

## Office of Head Start A-133 Audit Training Webcast

Ann Linehan: Good afternoon. My name is Ann Linehan, and I'm the Deputy Director of the Office of Head Start. On behalf of Yvette Sanchez Fuentes, Director of the Office of Head Start, I'd like to welcome you to today's audit training webcast. We have nearly 600 participants for today's live broadcast and nearly 300 participants registered for the rebroadcast on Thursday.

Your participation fulfills the post-award requirement that grantees participate in an Office of Head Start sponsored single audit webinar within one year of the start of your five year project period. However, more important than just checking off the box "you did it," we hope that every participant remains engaged throughout the webcast. Our over-arching goals for today are two-fold: to strengthen your organization's approach to obtaining a complete and accurate audit and to use the results of the annual audit to guide and influence the important fiscal decisions governing bodies and key management staff make throughout the year.

Before I introduce our three key presenters, I would like to introduce Jeannie Chaffin, Director of the Office of Community Services. As many of you know, Office of Community Services provides CSBG funding to states that support our community action agencies. And nearly one-third of Head Start grantees are community action agencies. Jeannie, we are delighted to have your support and partnership in this effort.

Jeannie Chaffin: Thank you so much, Ann. I'm pleased to be here today. Within the Office of Community Services, we do oversee the Community Services Block Grant and we're in partnership with the states to implement that important block grant, which is the core funding for the thousand community action agencies across the country that serve 99 percent of all counties.

We're pleased to partner with Head Start today because we really do share an interest in accountability. We also share a significant history. We have our roots in the Economic Opportunity Act of 1964. And as Ann said, many of the community action agencies out there are Head Start grantees. About 52 percent of community action agencies operate Head Start, and it's about 37 percent of all Head Start grantees are community action agencies.

Recently, we've been very focused on accountability at the national level for the Community Services Block Grant, and we've been working with our partners around the country, including the community action partnership, to develop a set of core standards for community action agencies. These core standards cover human resources, information technology, service delivery, and many of the financial aspects that we're going to talk about today, as presenting the audit to the board, bidding your audit out. And so, it's really timely that we would be here with Head Start today talking about this important issue of audits at the same time that we're finalizing our ideas about core standards for community action agencies.

So I'm pleased to be here and very pleased to know that we have many community action agencies on the line today listening to this important topic. So thank you, Ann, for inviting us.

Ann: Thanks. We're delighted to have you. Now, I'd like to introduce our three key presenters in the order they will present. First is James Krimmel, a CPA with Hamilton & Musser, and also associate professor of accounting; Belinda Rinker, Senior Advisor in the Office of the Director at the Office of Head

Start; and James Belanger, Director of Fiscal Operations at Danya International, also known as our monitoring contractor.

Before we begin the formal presentations, we hope to keep it light and engaging today. As each of the presenters are providing information, we are going to be commenting if we think there is something that is relevant or urgent. Or if you write in questions that are pertinent to the subject at hand, we will stop, take your question, and hopefully provide an answer.

So, Jim, why don't we start with you?

James Krimmel: Thank you, Ann. Well, it's about this time of year. Many of you participating today have a June 30 fiscal year end. And so if you look at the calendar, today's July 30th, so that means that you're gearing up and getting ready for your annual financial audit. I'm sure you're all very excited about that process. Unfortunately, that is typically not the attitude. In fact, all too often, you're anticipating this with your fingers crossed, your breath held, and looking forward to when it's over with.

However, the purpose of this session is to change that common attitude. We really do want to get past that, that idea that this is just a necessary evil that we have to do in order to meet our funding requirement. We want to replace that attitude with the title of this segment, which is "How Can We Make the Most of Our Annual Audit Process?" And I really believe that this can be a real learning process. It's not just a necessary evil. It's not just something to get done. It is something that we can learn from, and we can grow and our organization can better serve the children that are in our care.

However, in order to change that attitude, it takes both you as the leaders of your organizations and your auditors. Both must participate in that attitude change. As organizational leaders, you have a responsibility to have a top-down attitude change. There's no way that your staff – your lower level staff are going to take the lead on this. They won't; they can't. But if they see that you take this process seriously, then they will model that from you. They will take that from your model. And if you have a high expectation for the auditors and the audit process, they will see that and they will reflect that in how they handle this process.

But it's not just you. The auditors are involved, too. And I, as one of those auditors, need to recognize the importance of what we do. We must maintain our independence. Very, very important. We must be unbiased and objective. However, we can bring more to the table than just our audit experience. We need to bring value-added experience and expertise to the process. We'll talk about that and kind of flesh that out as we go through this. Not all auditors are created equal. You need to be – ensure that you engage the right auditor, the right auditing firm, the one that understands who you are, that has the right expertise and reputation to be able to do the work and bring that value-added service. And we'll – we'll talk more about that.

So let's look at what we'll be covering over the next hour. As you can see in the outline, why do I need an audit and if so, what type of audit do I need? Selecting the right auditor. Preparing for the audit. Navigating that audit process and avoiding common pitfalls. We'll look at a few of those things. And concluding the audit and learning from the results. And that's really key that we can learn from those results. It's not just accepting them. It's learning from them and growing and improving our organization. Then we'll have some time for additional questions at the end.

Okay. Why do I need an audit and if so, what type of audit do I need? Well, most of you – I'm assuming probably all of you – are participating today because you already are required to have an audit. So let's just talk about and maybe lay out a little bit of an understanding of what type of audit you need, because this is your responsibility, as we get to the point when we talk about selecting an auditor, to let them know what type of audit you do need.

As you look at the three levels of requirements here, these are what I call layers of audits. The generally accepted auditing standards, the YellowBook standards under governmental auditing standards, and the single audit standards under OMB A-133. All these are layers that are in addition to each other. So this is not "or." This is "and:" A and B and C. So in every audit – every organization that has an audit, must – their auditors must follow generally accepted auditing standards and have the ability to do that.

So if you are not funded by a grant that would require an audit, then maybe your bank or other financial institution might be putting that requirement on you; and a financial audit would suffice. However, then you receive government funding, whether it's federal funding, state, whether it's passed through a county or a local agency, if you receive \$300,000 up to \$500,000, then you would require a YellowBook or an audit based on governmental auditing standards. But that's in addition to it. It doesn't replace the financial audit. It's in addition to the financial audit.

And thirdly, if you receive currently \$500,000 or more of federal dollars – now, that doesn't have to be from one source. That can be from any number of sources: directly from the federal government, through the state as a sub-recipient of the state or a local entity or a county. Your grantors are responsible for letting you know where the source of those funds are and how much of that is federal dollars. If the federal dollars add up to \$500,000 or more, then OMB A-133 single audit standards also kick in. So, that would be a third layer.

Well, that third layer is – generates its own report also. So each layer has its own report. Usually in the front of the financial statements we have the audit on generally accepted auditing standards, then we have the YellowBook audit report, and the OMB single audit report at the end of the financial statements or separately attached or unattached. Either way, there's three reports and a wealth of information in those reports that you should understand and be able to learn from.

There are some proposed changes. OMB – single audit standards are considering to be changed at this point. They're not in effect yet, but if they do go into effect, that limit of \$500,000 will go to \$750,000. And it was considered at a million, but they've backed it down to \$750,000. So that could have some impact on some of you that are right over the \$500,000 mark of whether or not you're going to need a single audit in the future. There are other proposed changes in that – in those revisions that we will touch on a little bit later.

Also, the IRS currently does not require a single – an audit at this point, but some states require audits based on some of their particular funding – funding that you might receive from the state, so you need to be aware of that. If you're not required to have an audit – if you're not required to have an audit, then you have a difficult decision to make – a tough decision to make. Are you going to select to have an audit? Are you going to elect to have an audit even if it's not required? This is an expensive decision to make.

However, I would hope that your automatic decision is not going to be no, if we don't need an audit, if our funding does not require us to have an audit, if no one's asking us to do this, that we're going to

elect not to do that. If that's your automatic answer, it could be that you're not getting the value or not perceiving the value of your current audit. And maybe that's because you don't have the right auditor. Maybe that's because you don't understand the audit process well enough to know that it's bringing value to you even if it's not required. Something to seriously consider; and each board should take that decision very seriously.

Ann: And Jim, I think probably we have very, very few grantees that would fall into this category of not having an audit required, but we would certainly hold as best practice to have an external review of your financial systems regardless of the amount of your funding.

Jim K.: That's right, especially if you're in a situation where maybe this year you're not required based on your funding, but possibly next year you will. That – you don't want to get into the habit of an audit one year, not the next year, that could get you into a situation where down the road you would find that to be unfortunate and – and cause some problems. So – so, that is a very important decision to make.

Okay. Selecting the right auditor. Selecting the right auditor – there's a lot of issues that come into play here, and we will talk about this a little bit more in detail in a few minutes, but just to comment on a couple things to consider. Understand your needs, as I already mentioned. Know what type of audit you require. If you know what type of audit you require, then you know what type of auditor you need, because not all auditors – or not all firms are qualified to perform single audits or YellowBook audits. That is not a given. They must have a special type of peer review. They must have a lot of experience. They must have continuing education to meet the requirements of the YellowBook. And so, all those things need to be in place before you can select that auditor.

So, you knowing what type of audit you need is very important when you go out and look for a new auditor. The auditor's expertise, that's really important. Again, as I said, not all auditors are created equal. You don't want to just use the Yellow Pages and – or go on the Internet and find a list of auditors and just "eenie meenie miney moe."

It's a very important process that you want to go through to get the auditor that has the expertise that meets your needs based on your funding that you receive. Are they familiar with that type of funding? Based on your size, are they – have they audited organizations of your size? And that's not just large organizations. In fact, that's really important if you're a smaller organization that the auditor understands the nuances; and we'll get into some of that a little bit later when we talk about separation of duties.

Auditors' references; that's really important. And we'll talk – I'll mention this a little bit more in a minute, but the auditors' references, although you – you know, with job applicants, we can all give our favorite references and the ones that we know will speak well of us, but if we ask for enough references, it's going to get beyond that. And if you have the right questions to ask, then you can get beyond that, too.

And as I already mentioned, peer review report. Each firm must have a peer review report within – that cannot be any older than three years old. Every three years we have to go through the peer review process. So ask for that report, ask – read it, make sure you – that they had a pass. If there were any comments in there that you – that you should be aware of, take a look at them so you get a good idea of who you're dealing with.

Ann: Jim, is that peer review report on the individual auditor or on the agency?

Jim K.: It's on the firm.

Ann: On the firm.

Jim K.: It's on the firm. And that's – that's a good distinction, Ann; as to – to distinguish between the firm and the auditor who'd be working with you, and I'll get into that in a little bit. When you – when to go out for bid? This is a great question. A lot of people have this question. The default is: "I'm not going to do it. It's too much work. You know, I really don't like our current auditor. But it's okay; they meet the conditions. It's not a great process but it's just easier. I have too much other things on my mind to do."

Be careful with that because, again, this should be value-added. This should be an informative process. You're spending good dollars on this process, so let's make sure that we go out for bid and – and select the right auditor.

If you're dissatisfied with your current auditor, what could cause that dissatisfaction? Fees? Be careful with that. As we'll talk about in a minute, low bid is not always the best thing you want to go after. But fees are important. We recognize that. Expertise. Do they have the expertise? Experience is different than expertise. Experience means that they've been auditing for a long time. But if they've been a lousy auditor for a long time, that doesn't mean that they have expertise. One example, have they reviewed last year when – when Head Start teamed up with the AICPA and put on the previous webinar? Have they reviewed that? Have they gone through that process? Do they understand the nuances of your funding sources?

Service. And here's – number three and number four, service and no value-added assistance. ]If your firm is just coming out, doing the audit, you never see them until next year, maybe that's something you want to consider in determining whether you're going to go out for bid. Independence issues. If you're concerned about independence issues, and those things can change from year to year, you want to make sure that – that'd also be another good reason for going out for bid.

Belinda Rinker: And Jim, I think historically there's been some concern that it's hard to find auditors to bid in the more rural, less populated areas. But would you agree that, you know, with the ease of electronic communication, that getting bids in rural areas is easier now and might be a good time to go out and give that a try for some grantees who may not have bid recently?

Jim K.: Very much so. Very much so. Now the audit still should be on-site, but there might be less time that they need to be on-site and more things that can be done electronically so that their fieldwork time is less on-site. But you want – I wouldn't suggest they turn this into a box job, so to speak, where everything is done electronically, because that face-to-face working together is very, very important. But yes, I do think that – that it's different. I live in central Pennsylvania and there are a lot of rural areas, and – and auditors will travel. And we can make – those things are a lot different than they used to be.

The next point here, periodically to keep your auditors fees in check. You're satisfied with your auditor, but you're wondering if their fees are creeping out of control. That's a good point. And that may – that may be a good way to keep your auditor's fees in check. Not a problem with that at all. And that's – that would probably be a good suggestion.

What about auditor rotation? There's a lot of talk about this right now. And I hear from a lot of organizations that – they say, "Shouldn't we be rotating our auditors every few years, because doesn't Sarbanes-Oxley speak to that?" Sarbanes-Oxley is a federal act that doesn't have anything to do with you as nonprofit organizations. It regulates publically traded for-profit entities. However, it seems to be the – the area that we tend to look to as guidance.

Well, the original Sarbanes-Oxley Act does not require audit rotation – auditor rotation as far as firm audit rotation. And there actually has been a lot of discussion on this in the last few years. But there is, currently, in – in Congress a bill that would require that the PCAOB would not require auditor rotation. So that – again, that does not necessarily mean that it won't come down through to the nonprofits in another way. But this is something that does take some serious discussion as you as leaders of the organization.

Have you had your auditor too long? I hear the term "fresh eyes" on a regular basis. Fresh eyes also mean inexperienced eyes within your organization. So there's some balance that needs to be taken here. Usually those first couple years are an expensive audit process for new firms because they have a lot more to learn. That learning curve is pretty steep. So, somewhere, you need to balance the experience and expertise that your current firm brings and the fresh eyes concept of auditor rotation. So there is no answer to that, but it is something that's worth discussion.

Jeannie: Jim, are you saying that you should be driven by these kinds of factors that just went over versus a best practice time period for bidding out your – your audit?

Jim K.: Bidding out your audit and required change of auditors I think – I look at as two different issues. Bidding out your audit, most firms, most organizations will – will go out for bid for three years. And they'll try to stick – they'll have the ability to change within that three years. As long as everything goes okay, though, they intend to stay and contract that firm for three years.

As I – that is – that three years is quite important. If you decide you're going to go out for bid each year, be willing to change auditors each year, you're going to run into some real fee issues because it's – as a firm, we definitely take a third, probably, more time the first year. And so, it is a more lengthy process for us that first year because of all we need to learn. So if I can spread that out over three years, then that's okay; but if I have to do that every year, then that's going to raise the fees.

That is one of the major complaints about auditor firm rotation is that it's going to cause fees to rise, so that is a consideration. But as far as going out for bid each three years in order to see – and allowing your current firm to bid, if you're satisfied with them, that's a good practice. But the auditor rotation, saying, "We're going out for bid and we're not going to allow our current auditor to propose; we're going to change," is something that needs to be considered.

Ann: So there's rotation of firm as a possibility Ann: So there's rotation of firm as a possibility, but there's also the possibility of rotation within a firm of the auditor who's conducting it.

Jim K.: That's correct. And – and currently, the Sarbanes-Oxley Act requires auditor – lead auditor rotation. Now, that is a good thing. It can be a good thing. However, in a firm, depending on the firm's size, that there's not a wealth of expertise. You may be losing something in that transition by requiring your lead auditor to – to roll over every three or four years, because that – that person is the one that

can maybe help bring value to that audit. And if you lose that to a change of someone else in our office, that may not be the best for the organization.

Ann: And I think – when we talk about best practice, I think there are some Head Start agencies where they've had the same – and I say "relationship" because we're so relationship-based in Head Start – that they might say, "Gee we've had the same auditor for 30 years. He's a great guy. He's our good friend." So I think that's where we're getting into the extremes, where there has been no thought given to, "We should change this relationship," because it just feels so good.

Jim K.: That's right. That's right. And that doesn't necessarily disqualify them.

Ann: Right, right.

Jim K.: There should be – you want to look at the whole process. "They're easy." Well, that's not a good reason to keep them. "They're my friend. We golf well together." That's not necessarily a good reason. "But we feel like we're getting value-added services from this firm." Then years is not necessarily – I'm speaking from an auditor not a compliance person from a funder's standpoint, but I – what I don't want organizations to do is just say, "We must do this," without putting any thought into it that it becomes a routine, and without – without really considering the pros and cons, because there are both.

Okay. Going through the bidding process. Again, a lot of firms don't like to go this far because it takes work. However, it's really not as intimidating as it sounds. And – and also, if you have your board of directors – your audit committee of your board of directors, they should be very much involved with this. Creating a good list of firms in order to get that free and open competition that you're required to have with any type of bidding and creating a Request for Proposal.

Now, I do have a copy – just an example of a Request for Proposal in the Appendix. We're not going to go over that specifically today. However, that can be – just give you a guide. I've received Request for Proposals, or RFPs, that are a half a page long and 10 pages long; very complex, a lot of information that may not be helpful. This one is pretty middle of the road. It asks a general amount of good information, a lot of things that are covered in here, and is not overly burdensome on anybody, either the ones responding or you in considering those proposals.

Where do you get that list of firms, though? That's really important. Referrals from colleagues. This has got to be the key. This has got to be the key, because each one of you – there are 600 of you watching today. Well, you must have colleagues with – in similar organizations or across town or across the state that you work together with your association, that you can say, "Hey how do you feel about your auditors?" And getting those – those references because the auditor will tend to give you references that they know will probably give them good comments, but your colleagues that you have worked with are going to give you their honest opinions.

So getting a good list of firms' referrals from colleagues, great way. And not necessarily just in your type organization; around your town, around your community, with other nonprofits in your community. Ask – just ask. Ask your colleagues. Great place for that information. Most states have an association of Head Start organizations. Ask them. They'll – they'll be another great source. The AICPA and your state institute CPAs can also give you some – a good list. But again, that's pretty generic when you get to that point. A good referral from a friend, someone that you trust, is going to be a great way to start.

Drafting the RFP, you want a clear description of the services needed. As we've said a couple of times, the type of audit that you need. And again, that's your responsibility. I walked into an organization just within the last six months and sat down and looked at their prior audit when they were going out for bid, and I said, "It looks like you are required to have a single audit." And they hadn't had one for the last two years and they needed one. But just by looking at the funding sources, I could tell that that's what they needed. And they didn't know it, their prior auditors didn't know it, and they had a lot of hassle trying to figure that process out after the fact. So, know the type of audit that you need. Be aware of that.

The IRS returns that are supposed to be filed, whether it's a 990 – 990-T... How many of you are aware of the health care tax credit that many, many nonprofits have been able to take advantage of? We have helped many organizations get significant refunds – not refunds, but credits back from the IRS for the health care – the health care credit. And there's a lot of nonprofits that aren't even aware that this exists. And it's only good for a couple more years, but you can go back over the past few years. But again, know what type of returns you're looking for. Even including a 5500, if that's required for your – for your retirement plan. These things should all be listed so you can compare apples to apples with your different proposals.

Specific items to include in a proposal, again, most of this we've said. Experience; that's really important. Expertise; again, that goes beyond just years of experience. That's the type of work that they've done, the type of auditing that they've done, the type of clients that they have. The references – how many? More than two. Five, six, I would suggest. And – but not only ask them for references, but references based on funding sources that are similar to yours. Maybe not the exact same funding source, but similar to yours.

If they single audit – if they've done single audits, obviously that's very important. And also size of organization. And maybe you can ask them, "Tell us what the revenue is of the organizations that you're listing as your references." That will give you a basic idea of – of size comparison, because that does make a difference.

Staff levels working on the audit. This can't be overemphasized, in my opinion. You might have the person with great experience and expertise sitting in your office before the audit takes place while you're soliciting proposals, but then you never see that person again. So who's going to be the staff on the premises? They're the ones that are going to be looking; they're the ones that are going to be watching.

I talked to an organization the other day that said that they selected a firm based on the people that came to the pre-proposal meeting. And when the staff showed up, there wasn't one person over 25 years old. Not that they don't – not that those aren't well-trained, but they don't have a lot of experience and a lot of expertise at that point. So ask, "Who's going to be here?"

Are you going to be a small fish in a big sea or a big fish in a small sea? Another consideration. A lot of – a lot of organizations say, I need to have this well-recognized firm name that I can trust, and I'll pay whatever it is to get that." Well, are you, again, content to end up being a very small fish in their big sea and not get the attention that you as an organization deserve? So matching a firm with the organization, very, very important.



Expectations of the use of your staff during the audit. Make sure that that's clear. What type of work are – are you expected to do for them? Fees, as I've already said, three years is typically what you're asking for. Watch low bid. That's not always the way to go. Low bid – There's always going to be a firm out there that's going to go low, and that's – just be very careful with that. It's not automatic not to select them, but make sure that that's not such an overwhelming priority to you that you select that automatically. Fees are not necessarily proportional to revenue. If you have an organization across town that you are familiar with that has – that is five times your size revenue-wise, you shouldn't expect a fee that is one-fifth theirs, necessarily. It's not that proportional because there is a base level of work that must be done in every examination. So – so, just keep that in mind as you're going through that process.

The peer review report, request a copy of that, as I've already mentioned. And these value-added points, number 8 and 9, how does the firm handle periodic questions throughout the year? Are they going to bill you for every time you call them? Are they available? Do they welcome those questions? That's the type of information you want to get. And that's the type of questions you want to ask to the references.

How available are they? Because they'll tell you they're going to be available, but you want to hear from your colleagues and from their references how available are they. Are they available to you? Are they willing to answer questions throughout the year? Do they bill you for that or is that part of their audit proposal or their audit fee?

And how does the firm educate and inform their clients? In the last six months, we've had two seminars that we've invited our clients to: one on fundraising techniques and another one on the health care act and how it's going to affect their organizations. These are valuable pieces of information. Do you have access to a newsletter from your – from your auditing firm? How do they keep you informed? These are the value-added things that a firm can bring that some firms will not be able to do.

Include a deadline for the proposal, evaluation process, how you're going to evaluate that, date of the decision. Just basic information like that.

Belinda: Jim, could you tell us a little bit more about what we might find in the peer review report?

Jim K.: The peer review report has changed relatively – just a few years ago. Basically, you're going to look for the word "pass." In the last paragraph of the report, it should say, "It's a pass." That's not – that's the word that we use. It's not going to say, "Pass with flying colors," or "Pass just barely." It's just the word "pass" – is what's going to be in that report. If they have a letter of comments that comes with that, that's not necessarily issued anymore with a report like it used to be, but you can still ask. Did they get a letter of comments with their – with their – an opinion – the pass opinion? So, that can be helpful information.

Belinda: Great.

Ann: But there's not a fail?

Jim K.: There is a fail.

Ann: There is a fail.

Jim K.: And if there is a fail, then this is not the firm you probably want to be selecting. Absolutely.

Evaluating the proposals and selecting the auditor. This is a responsibility of the governing body, and this is a good audit committee role, a very important way for them to – to carry out their fiduciary responsibility. If you have an audit committee, if not, just your board as a whole, is – can act as an audit committee in selecting that – that firm. Narrowing to the top two or three and then having interviews, because the proposals are very helpful information. But you want to see fit, and you can experience that in a face-to-face interview much easier than – than with even a phone call.

Developing a scoring system. Again, this is just a suggestion, but you might want to think about it. How are we going to evaluate all this information? Assigning certain points to fee, certain points to experience, and the references, certain points to the interview, and the quality of the overall proposal. This is a very subjective decision-making process. However, we can quantify it somewhat and make this a little more objective by setting up some type of scale or scoring system. Just a suggestion.

And then you select and inform the new auditor that they are now your auditor. The transition phase is why a lot of people don't do this, because this is – this takes more of your time. I recognize that, but – but it can be well worth the little bit of extra time and effort on your part. And just a couple bullet points here to put out real quickly. Inform your prior auditor and give them permission to discuss this with a new auditor because your prior auditor is not allowed to talk to your new auditor because of our confidentiality requirements unless you give them permission.

Some will actually ask you to sign a document that will give them written permission for their files to talk to the new auditor. Then your new auditor will contact your prior auditor and ask them some very specific questions about you, about your organization before they're going to sign the bottom line on that engagement letter and take you on as a new client. That's an important part of our – our professional standards. And then I – the new auditor will also then go out to the prior's – prior auditor's office – review the work papers of the prior auditor. That's all normal process.

You might want to, at this point – and we'll mention this in a little bit also again – if not offered – hopefully they do – request the new auditor to prepare an extensive list of items that should be included and that you should have ready for the audit so that you are ready to start working on that and what – what their expectations are for you. Expect more questions and more time of yours to be used in that first year because there is a big learning curve on the new auditor's part. But again, that is primarily that first year.

The audit committee's role – now that you've selected your new auditor, obtain and review a signed engagement letter. Make sure that the engagement letter includes the fees that were already discussed in their proposal, and also the proper type of audit so that they – you both are on the same page as to what type of audit is needed.

Belinda: So Jim, is the engagement letter in the nature of a contract for the audit services? Is that what memorializes the discussions that have taken place so far?

Jim K.: It is. The engagement letter is required. Your auditor, if they say they don't need to have an engagement letter, they're wrong, because it is required by our standards to have a written engagement letter and – signed by both parties. And so, you want to make sure that that's done. But that is – that's correct. That's a contract.

And we – we typically avoid more than one year; because the proposal might have been for three years, but you – you don't want to lock yourself in. That's – that's an intention to keep that auditor for three years, but there's no commitment. If – if it didn't go well that first year, you want to have the ability to get out of that. And so – plus, things could change from this year to next year to the following year, so single-year engagement letters are the way to go, even if you have an intention of keeping that auditor for three years.

Still with the audit committee, up a meeting with that new auditor. Now that you have obtained them and signed that engagement letter, that conference call at least or face-to-face meeting to discuss timing, deadlines of the audit, the deadlines of the regulatory returns, and your expectations. Make it very clear what your expectations are for them. And set up a post-audit meeting. This is very, very important. We want to make sure that you, as leaders of this organization, are part of that post-audit meeting and – as part of the governing board or specifically even the audit committee if you have one. And we'll talk more about that in a few minutes.

Management's and financial staff's role with this transition. Establish the audit fieldwork dates as early as you can, both – maybe an interim date and a year-end date, the fieldwork dates. And by the way, this is a very good point. Notify your Head Start office so that you don't have – even though you love your monitoring visits and love your auditors, you probably don't want to have them in there at the same time. So as soon as you have your dates set, let your – your Regional Office know so they can make sure that the monitoring visit doesn't take place at the same time. And again, as I mentioned, request that list of items that you want to have – that you need to have ready for them when they come in.

Navigating that process. Navigating that process. By the way, one last point with that. Make sure that, as the executive director, that you are available for that audit period. Now, I know that you're busy. And when I come into an organization and the executive director says, "I will not be here for the three days or five days, or whatever days you're going to be here. Can I we – can I call you afterwards?"

That sends a message to me, it sends a message to their staff, that this is not that important to you, that you don't take this that seriously. At least, that's the – that's the perception that's going to be given by that, whether you intend it to be that way or not. So... Now granted, you may not be able to clear your slate for the full period of time that they're there, but you want to make sure that you are available enough to – to learn from this process and see how it goes, and support your staff and support the auditor's process. I think that's very, very important.

Navigating the audit process and avoiding the common pitfalls. We could spend a week of these workshops just discussing some of the things that I'm going to take only a couple of minutes to discuss here. So I want to make sure that you recognize this is not everything, but they are important points.

The financial audit. Again, all audits have to have the financial component to that audit. And I only picked on cash here because cash is – is key pretty much as an organization. Yes, yes, you might have your financial statements on what we call the accrual basis of accounting, and so there's all kinds of things that need to be done, but you live and breathe and – cash, in and out. Basically as an organization, fundamentally you are cash in and cash out. So, the protection and the control of that cash and accounting for that cash is key. It's very, very, very important.

Bank reconciliations need to be completed and be accurate on a monthly basis, and they need to be timely prepared. If you're preparing three four months at a time, that's not really – that's not good at all. I tell clients on a regular basis, and I tell boards that I'm sitting on, I do not want to see a set of financial statements until I know the bank reconciliation's been done because I do not know that those financial statements are accurate until that point.

I really cannot... You say "Well, it's only off by this." Well, as auditors we love the word "materiality." Is it immaterial? In fact, the term flows through the literature a lot – material findings, material this, material that. And it's kind of a term that we – we like to throw out. But when it comes to bank reconciliations, that term should never be used. A bank reconciliation should be to the penny. Because the common saying is if it's off by \$2.95, it could be \$1,000,000 off this way and \$1,000,002.95 the other way. And that is how a lot of frauds are – are hidden within the financial statements, through an inappropriate or not adequately prepared bank reconciliation. Very important that we get that right.

So this is not an area where we say, "It's close enough." It's very important that we reconcile that. And if it needs to be adjusted, it needs to be adjusted, but then we know that – what we're doing when we're doing that.

Moving on to disbursements. All disbursements need proper documentation. Proper documentation, that's very important. If not, these are going to end up as question costs. Documentation is very important. And we get this question a lot of times – online payments. "Well, I – I bought this thing online so I don't have a receipt." I have never seen anything purchased online that you can't print off a receipt. So, print it off. Just print it off.

Now, there are some real slight exceptions. In Pennsylvania – in this region, we use what is called the E-Z Pass system, where you hook up the little monitor in your car to – to a credit card and as you go through toll roads it just records that and there is no receipt, like we used to have for the Turnpike. That's not – so that might be an exception, that it – that that's a charge to the credit card. But there's not too many like that that you cannot – and even there, you can print off a record of every time that's gone through that toll. So, very important that online payments – and there's a lot more being done of that, of buying things online – that there's good documentation.

Credit card charges. Credit card charges. The credit card statement... If I'm your auditor, the credit card statement is not adequate documentation. I want original receipt. I want original receipt. And that's – that's appropriate. Original receipts attached to that credit card. Very important. Employee expense reports, same thing. Now, adequate records for – for mileage. We understand that that's – that's a good using a log is important there. But – but other than that, anything else that's being reimbursed there should be, again, original receipt. Payroll disbursements, specifically with shared staff.

Contemporaneous time records. We'll talk about that in a minute when we get into compliance, but that's very important. Contemporaneous time records. When I see time sheets that look – that are pre-printed, typed, photocopied, and signed, and they have the exact same hours for that employee every month and the same programs that they're being charged to, that doesn't sound very contemporaneous to me. It doesn't look very contemporaneous. So it's very important that we keep live, contemporaneous time records for our payroll. Very, very, very important, especially if we have shared staff that are amongst different programs. That's really important that they have the proper documentation to support that – that difference, which we'll talk about in a minute when we get to the cost allocation.

Revenue. Just a couple comments here real quick. All federal grants need – have a CFDA number. That's the – the identifying number. If you – your auditor's going to need that information in order to put that on the schedule of expenditures of federal awards. That has to be reported, and that's the only way that you're going to be able to identify where that funding source came from. It's your responsibility to obtain that. You may not know it, but your grantor should know it. So somehow, you've got to kick that question back and make sure that that information is available from wherever those funding sources are coming from.

Oh by the way, real quick with disbursements. One other point just real quickly. Be familiar – [Clears throat] excuse me – with A-122. That is the circular that – that tells you what type of costs or disbursements are appropriate for that single audit. Actually, there's two other circulars for different types of organizations. One of the other proposed changes with the revisions of the Single Audit Act are going to be to combine the three and come up with one new circular that – that has all three, which will be – I think will be a good thing.

The compliance audit. Jumping down to the compliance audit. When you are audited under the second layer or the third layer of standards that we talked about earlier, governmental auditing standards, YellowBook, or the single audit standards, then the compliance audit kicks in. You are going to receive a report under those two sets of standards that are – that are reporting on your internal controls over your compliance with the laws and regulations that came with those funds and the compliance itself – itself with how well you are complying with those laws and regulations. So those reports are going to have valuable information.

But what are some of the things that we see on a regular basis, these pitfalls, that I want you to be aware of? Internal controls over compliance. Internal controls over compliance. Separation of duties, or segregation of duties. This is really important.

Now some of you might be thinking, "Oh, yeah, yeah, yeah. Every – every year our auditor comes in and says, 'Look, your organization's too small. You don't have enough people in the office to be able to have proper separation of duties, so just accept the fact we're going to write you up.' " That is not value-added. In my opinion, we can become very creative, not getting around this, but setting up an internal control system so that there is proper separation of duties in small organizations. I work with a lot of relatively small organizations, and – and thinking through this is where I bring value to that organization – where we can bring value, where your auditor can bring value to that organization.

As a certified fraud examiner, along with being a CPA, this is extremely important to me. I do not take this very lightly. I've traveled the world, literally, talking about lecturing on and evaluating internal controls for small or international nonprofit organizations that have small operations in developing countries. And there's very creative ways we can deal with this or compensate for that lack of numbers of people involved if we are thinking clearly on this and if we're taking the time and bringing that value to this.

Jeannie: Jim, I might just mention regarding this – this example that you use that a small agency auditor just says, "Well, we're going to write you up on segregation of duties. You're small. It's, you know, just what we have to do." In today's accountability environment, that can have some really strong repercussions in funding and...

Jim K.: Absolutely.

Jeannie: ...competition for other grant funds. So I really appreciate what you're saying about, you know, be in a relationship with your auditor to have them help you figure out how to change that situation...

Jim K.: That's right.

Jeannie: ...because you don't want to be in a situation where you have to explain that to other funders and potential funders.

Jim K.: That's correct. And where I see this the most – and I don't – I'm not going to bust on my colleagues – but if a larger firm is coming in and auditing a smaller organization, they may have the name and a lot of the expertise, but they're not used to working with small operations. And so, they don't – they can't think outside the normal box of we have one person that does every – or one person that does this, one person that does this, and we have – because we have six people in the office that we can separate this with – or 10 or whatever.

If we have two people in the office doing financial duties, how do we do this? It – it takes creative thought and thinking and – and a lot of experience with other organizations in a similar way – that are set up similarly to be able to bring that to the table. So it is – it's not just an automatic, and it shouldn't be because this is... Way too many frauds stem right back to this, and so this is not something you want to take lightly.

And so, we look at these three duties, and I want to – I want to mention this just to give you a quick little overview of the three duties that we want to make sure are properly separated: authorization, custody, and recordkeeping. I would suggest that, as I'm speaking about this, that you think about the people in your office. Think about – you can put names to them; I can't. But you can put names to them and think, "Okay, who – who has this responsibility?" And these are not all-inclusive definitions, but it will give you an idea.

Authorization. Authorization. That's the person who authorizes transactions. For instance, a person who signs checks. If you're using check-signing, which most – small or medium-sized organizations still use signatures on checks as an authorization function, as an approval function, that – or approving purchases or whatever, that person who has authorization. That's a particular function.

Custody. That's the person who can touch the assets of the organization, and we'll talk about cash here. Cash – what I mean by that is not just currency, but cash and checks coming into the organization. Those who have access to your direct draws for your Head Start. That – the person... That's a custody function. Those who can send out wires; that's a custody function.

Recordkeeping is that – those people that have direct access to your accounting records, and specifically, your general ledger. No person – no individual should have more than one of those responsibilities. No individual should have more than one of those responsibilities. You say, "Well, that's almost impossible. We can't. We just can't. We don't have three people." Well, how do we do that? That's where we have to get very creative in this and look at how can we compensate for that.

Some of the things that I typically see here, and I'll just throw out a couple. The bookkeeper handles cash. The bookkeeper gets – opens the mail, sorts out the invoices that have to be paid, sorts out the

cash and checks – not currency, usually checks, and then makes the deposit, records them. That is not good, because now that person has custody and recordkeeping responsibility.

You say, "How do we deal with it?" Someone needs to log those checks prior to them being touched by that bookkeeper. It doesn't mean the bookkeeper can't touch them. It doesn't mean the bookkeeper can't make the deposit. It just means the bookkeeper can't touch them first. Someone needs to make a record of what came in and then loop around with the deposit slip to make sure that everything that that person touched – that came into her ended up going to the bank. We can do some creative things to help compensate for that lack of separation of duties.

Executive director signs checks, has an authorization function – typically is a good thing – and also has full access to the general ledger. And okay, I'll use QuickBooks as an example. Okay. QuickBooks can password protect and it can also allow the executive director... Most executive directors that I deal with need to be able to get into the accounting records, need to be able to print things, need to be able to read things, need to be able – but they don't need to change anything. And so, password – set up their password so that they have read-only access.

Okay; now they have access to the accounting records but they can't change anything. Now – now there's not a conflict in their authorization and their recordkeeping responsibilities. If the bookkeeper's signing checks, that's a real problem. It's kind of hard to get around that, except we don't – the bookkeeper shouldn't be signing checks; unless there's two signatures, and that may be able to be okay, but we'd have to talk about that on an individual basis.

Signature stamps. Oh, my two pet peeves as an auditor are the next two, signature stamps and corporate credit cards. I hate them. I'm just saying I hate them. Now...

Ann: Tell us how you really feel, Jim. [Laughter]

Jim K.: Signature stamps. What I often hear, "Well, we have a signature stamp, but it's only used for letters. I send out a lot of letters and I don't want to..." The executive director, "I have check-signing authority but I just want to be able to stamp the letter." Well, here's the difference. Here's something to keep in mind. If someone in your organization forges your signature on a check and it goes to the bank, the bank is responsible for that. That's forgery. That's the bank's responsibility.

If they put your name on the check through a check stamp, that is a live signature. That is your responsibility. So from a legal standpoint, they're totally different. And so, a signature stamp is your signature. I've suggested a simple way of doing this, of saying okay sign your letters without your middle initial if your middle initial is in your signature on your check that is registered at the bank. Then it's two different signatures. Then it throws it back into the bank situation.

So there's ways you can think around this. But signature stamps, I just say get rid of them. Live signatures are much better. If you are using the signature of a check as part of the authorization function, if you're using electronic signature on your checks, then the approval process and the authorization has to come before that.

Corporate credit cards. Corporate credit cards. In the last two years, probably I've had more employee – client employees be reprimanded, fired, and prosecuted for corporate credit card problems than any other thing. Corporate credit cards are a tremendous convenience. They bring tremendous convenience.

But here's what we do. We set up 38 controls over getting a check out the door, and then we hand anybody who wants to a credit card, or we post a credit card number on the bulletin board so that everybody can use it.

Yeah, they're convenient. They're very convenient, but they can be easily abused. Make sure that your corporate credit cards have the same approval and authorization process that a check going out the door should be, because we're not just using these for small purchases. Typically, we'll buy our computers and a lot of other things online using these corporate credit cards. A lot more I could say about those.

Wire transfers, a similar problem. Many of you probably aren't doing wire transfers out, but if you are, make sure that you are – have dual control. We always like dual control. I compare it to your safe deposit box at the bank. You can't get in by yourself, the bank can't get in by themselves. It has to take both of you. Well, wire transfers often can be set up so that the bookkeeper can wire money out of their account to another account. That's not good. Now, if it's in the same bank from your savings or your checking, that might be a different story. But outside the bank, that's a deadly mess and – and you have to be very careful with that.

So a lot of banks will offer, if you ask them for it, that the person can set up – the bookkeeper can set up with one code and then the person authorizing it – the executive director, board member, whatever – who has a secondary function can release it with a separate code. And those codes should not be exchanged, obviously. So we can put protections in there, but those corporate credit cards, signature stamps, wire transfers, are the things that sometimes end up outside the normal process that we look at and cause us significant problems.

Compliance elements. Allowable costs based on OMB A- 122, I already mentioned that. Cost allocation. Not your cost allocation plan. If you have multiple funding sources, the federal government is very clear. "We will pay for our fair share." Now, granted, you can say, "It all came from the same place ultimately." But if each department is sending out their funds, they will pay for their fair share. That's it.

And so a good cost allocation plan is necessary, and it can't be based on budget or revenue because expenses don't necessarily correspond with revenue. And if we allocate based on revenue or budget, then we're – then we just are in a vicious circle of not knowing what it really costs to run this program.

And when I suggest to my clients that they need to have – or a new client that they need to have a good cost allocation plan, I always like to tell them, which I really believe in, that this is not just to meet your funding requirements or to meet my requirement of you. I see this as extremely important. I liken it to a manufacturer who produces 10 products. If you're a manufacturer who produces 10 products, is it sufficient for you to know that you're making a profit in total as a company, or – or do you want to know what each product is costing you so you know what each product is doing for you?

Well, your programs are your products. Each one of your programs are your products. What is each one really costing you to run? Are you running a program at a loss? That would be helpful information to know. If you have a good cost allocation plan, you can manage your organization much more effectively. If you're running a program at a loss, you may have to make a decision. We're going to get rid of the program. We need more funding for that program.



But now you have a basis for going after that or additional – another funding source, or go and do some fundraising to help. Or you might say; "We just are going to run that program at a loss. It's too important to our organization. But we better have some other funding sources that are unrestricted in order to cover that." But we need to know. So it's – this is not just to meet a requirement. It's value-added to you. It allows you to run your organization better. But it also meets a very important compliance requirement, and it's a typical problem – a very typical problem.

Now, how to you – what is the basis for that cost allocation plan? Time is usually a good indicator as a cost allocation base. By the way, your auditor cannot prepare your cost allocation plan, but they can give you some recommendations. They can help you with it. They just cannot prepare it for you. We're not allowed to do that. However – again, time is a good cost allocation base. Where time goes in your organization, so does most other costs. And so, that's usually a good indicator of where your other indirect costs should be going. But other allocation bases, for instance space, as far as rent and utilities go, can also be another allocation base. But this is a very important process here – an important part of this.

Direct... Next slide. Direct funding from the federal government. If your – if your Head Start funding or any other funding is direct, in other words you can go onto the Head Start website and draw down, a common – too common problem is that this becomes a line of credit for the organization. You say, "Yeah, but I have three other funding sources – five other funding sources and they are cost reimbursement, and it takes the – the state or whatever two months in order to reimburse me. Well, so I – I need..."

So – so your temptation is to draw down those funds prematurely. You have three days – three days when those funds hit your account to get them out, and we look for that. You need to develop a good cost – cash management system in order to maintain that. And it's not only that. You might have state requirements on top of that with some of your other funding sources.

So your – your cash management or your – your Head Start funding, or any direct funding from the federal government, cannot be your line of credit. You may have to consider setting up a line of credit. Or what I tell a lot of clients, well then don't bill the state every two months, bill them every two weeks and get this process, get the cash flow going on a more – more regular basis. Those are just some – a handful of the issues that we tend to see on a regular basis.

Ann: I have to say, you hit most of our hot spots in Head Start. We're smiling because these are often the things – I mean, the very issues that you're talking about are exactly the issues that I think are – are challenges for some of our Head Start programs.

Belinda: And even in the expenditure of cash drawn down, I know that from a general audit perspective it's three days. I believe the grant's management expectation is that those funds be expended by the end of the next business day.

James Belanger: That's part of the grant's policy statement.

Jeannie: I would also add that, you know, I've been kind of looking back over the core standards that the Community Action Network has recommended. And cost allocation, audit bidding, audit selection – many of the items we've talked about are in the core standards, so I think that's very encouraging.

Belinda: And Jim, I think back to the time I spent in a program, and you've hit on a lot of issues that were challenging as a small program that I don't think I ever understood I could seek the assistance of my auditors in resolving. So some of those internal controls issues, some of those concepts of what are appropriate bases for different types of cost allocation categories, I think having that value-added conversation is something that, you know, if I were still a grantee, I would really take away from your discussion; that I can leverage the fairly costly audit process by getting additional information and making sure that, you know, without compromising independence, I get added information that helps me better run my program.

Jim K.: I think that's a very good point. And if you're aware – if you have been written up for separation of duties for the last several years and there's – and you're interviewing new auditors, how would you – I was asked this question, "How would you help us through this particular situation?" And on the spot, I had to work through a possible scenario that would help relieve that situation.

And if they asked everybody that, they're going to – they're quickly going to bring that list down to those that are used to working with that type of organization. So again, not all auditors are created equal. They may have the experience, but they may not have the expertise with organizations of your size and your complexity or lack of complexity.

A couple final things that I want to mention here. We're back a little bit further than that. Concluding the audit and learning from the results. Yes. Next slide. Management and accounting's... Management and the accountant's exit meeting. Here's where – hopefully the whole audit process has been a learning process all along the way, but this is very important here.

Recommended participants here would be those that are responsible for the financial – you might have this as a two-phase meeting. Let's bring the bookkeeper in and anybody else that's been working with the financial operations of the organization. And then you want to give the auditor an opportunity to speak to those individuals with them not present, so you may want to have a phase two to that meeting. But you want to get as much from this as you can. And if this is where you have a meeting 15 minutes later, you're going to give the impression that this is not important.

So this is really important that you separate – that you set aside adequate time to address the things that need to be mentioned to you, by your auditor, as well as... I am surely not the type of auditor that generates management comments just for the sake of doing that. Some firms tend to go that way. I don't want to do that. That's not my – my philosophy. But – however, if they have nothing to say to you in this meeting, that you're perfect, then that's probably not good either. So – so this is important information.

Don't be defensive. Very important. Don't be defensive. If you are automatically defensive at this point, then the learning process is going to be squelched. And so, be – have an open mind, listen to what they're going to say, and make sure that you understand what the reports are saying. Have them explain – have your auditor explain them to you. If they can't explain them, shame on them.

And a couple points here that I will jump into really quickly, because I know Belinda and Jim are going to touch on them also, is understanding your audit reports. We list here the opinions that you can receive. The unqualified opinion. When I talk to my students about this, usually they're seniors in an auditing class and they're going through the interviewing process, and so they get these words backwards. They

think, "Unqualified, that's not what you want to hear in a job interview. Qualified is what you want to hear." But that's just the reverse here.

Unqualified means that there's no exceptions in your report. We found no exceptions, or no reason to say that your financial statements are not presented fairly in accordance with U.S. Generally Accepted Accounting Principles. The qualified opinion is saying, "Except for this issue, everything else is okay. Except for this issue, everything else is okay."

Without getting too in detail here, there's two different prongs to that qualification. It can be an accounting issue, that you're doing something wrong, and so they qualify based on the fact that that accounting is not being handled correctly; or it can be an audit issue, and – and by that I don't mean that the auditors are doing something wrong, it's just that their audit procedures were stifled in some way. You lost some records, you – they were damaged, or something else. So they weren't able to do everything that they were supposed to do in order to audit you. So that's an – that's an audit issue versus an accounting issue. So either one of those can generate a qualification in your audit report.

The third one, adverse opinion. That says that, basically, we can't say this... We're not allowed to say, "Except for this and this and this and this and this and this and this and this, everything else is okay," because there's really not much of anything left. So when it gets to that point or if the issue that we did find is so significant from an accounting standpoint – and this is purely from an accounting standpoint – we would have to issue an adverse opinion, which basically says, "Your financial statements are not presented fairly." It's not, "Except for this." It's just, "They are not."

Disclaimer of an opinion is not an opinion. That says what it is. It's saying we can't give an opinion. So that would be an extreme audit problem. Your records were destroyed. They cannot issue an opinion because they couldn't do their job. They couldn't do the work that they would need to do in order to express an opinion, so they would disclaim it. Another reason for that could be an extreme uncertainty, like a litigation or something like that.

Other important terms to understand: going concern. Each auditor, every year, must evaluate your ability as an organization to continue into the foreseeable future at least one year. And so, they – this is subjective, there's no doubt about it, because we don't have a crystal ball. But we have to evaluate whether or not there are conditions within your organization – spending at a deficit; spending your deferred revenue this year, really for next year; spending your restricted dollars, whatever, for unrestricted purposes – things that are – or loss of staff or loss of children or loss of key personnel or management – things like this that – that would cause us to consider that you may not be able to continue as what we call a going concern into the future.

And if that's the case, we have to modify – put that modification in our – the first report, the – the GAAS report, Generally Accepted Auditing Standards, the report that's upfront, mentioning that you will not that we – we're concerned that you will not continue as a going concern.

Ann: And – and Jim, just as a place holder, because I know Jim and Belinda will probably address it also, but this going concern has taken on greater importance because it is now under our Designation Renewal requirements under 1307. It is one of those conditions that if an agency has a going concern, then that agency is required to re-compete for its funding.

Jim K.: Well – and from an auditor's standpoint, this is a really difficult thing because I – this is someone's organization. They – they live and breathe this every day. And so, what I – what I say can have damage. But don't just accept this. If your auditor says – don't give them the easy out here. Push back, because you can show them mitigating circumstances. "We have – we have a new signed contract."

You can't just say, "Oh, I know we're going to do this. We pulled out before." It's got to be... You've got to be able to show them facts that – that would help mitigate their concerns. So, don't just accept this. It may not go away, but you – you do have the ability or you have the responsibility to push back on that and to see if it is... Don't give them the easy out. This is just an easy thing to do.

Ann: But the importance of the independent auditor, he or she is not going to be influenced by that pushing because without that identification of a going concern, that board – that governing body, if they're not reading the entire audit, may think that they're okay.

Jim K.: Absolutely.

Ann: I mean, you want to know how severe the condition is so you can fix it.

Jim K.: We don't want auditors out there just giving going concerns because it covers their bases just – when it's not necessary. It is subjective. But – but on the other hand, absolutely, because then when the banker all of a sudden is default on their line of credit, they're going to come looking at the auditor. So, it is very important to us. That's right. But I'm just saying it's – it's worth at least finding out why and questioning it and giving a little bit of push back. It may not go away, but you – you should at least explain – understand exactly why that came about.

Other important terms real quickly here. Really, b and c should be a – another one in there. We have a deficiency. You can have a deficiency, a significant deficiency, or material weakness, in your internal control. And those are – I said that in the order of severity. Deficiency, there's a normal deficiency. Deficiency is one that's not on this list, but that's – that could even be a verbal comment that came to you. That does not have to be in writing. A significant deficiency or material weakness, the auditor's required to put that in writing and it will impact your – your YellowBook and your single audit reports.

Material noncompliance. Again, there's the word "material" again. Material noncompliance is you're not complying with the laws and regulations that come with your funding in a material way, in a significant way.

The next slide – require that all findings come with a practical and cost-effective recommendation. Again, this is a value-added thing that I'm talking about here. Too many auditors are quick to criticize, quick to find – have findings, but then they're not going to give you their input. They're not quick to give you their input on how you can rectify this. And the answer is, "Well, you're too small," or "There's nothing you can really do about this," is not satisfactory. Ask them to work through with you to come up with recommendations for improvement.

And you are responsible for your corrective action, putting it into place, but they can help you come up with a way of correcting this condition in a cost-effective way. For them to say, "Well, you need to hire two more people," that's not cost-effective. So – push back on that. Make sure that you're getting that value-added experience and expertise from your auditor.

And be familiar with what is included in the management letter and in your – in your two – your YellowBook and your A-133 report. You should not be surprised when these reports are drafted. And this exit meeting at the end – at the end of the audit, you want to be sure that you're clear on what's coming. By this time, they should know what's coming. And so, you don't want this to be drafted and all of a sudden you're back-pedaling to try to figure out how to explain this to others in your organization. This shouldn't be a surprise at this point. Use this meeting to register any concerns you have with them, with the audit process, how it can be improved next year. This is – you are part of this. It's not just them dictating this process.

And lastly, make sure that this is a learning process. Again, don't just accept this and – and plug your ears and say, "We're 15 minutes away from being done this and next year I'll have to deal with it again." Learn from this. Make this a learning process. Make them participate in how – how to – this to be a learning process for you.

This is management, but the board of directors, the audit committee, or those in charge of governance should also be involved with this. This should come directly from the auditors to them. It shouldn't necessarily pass through management. If you are doing your fiduciary responsibility as a board member, then you need to be hearing this stuff from your auditors. A face-to-face meeting is highly suggested, where you hear about these findings or that everything went well, if that would be the case. But that you're – that is your responsibility as a board member, to make sure that you are hearing directly from the auditors in this process, again, to make that a learning process for you too. Okay.

Ann: That's terrific. We have a couple of questions. And you know, I was sitting here thinking, I'm not a fiscal expert, but, boy, I could understand clearly everything you have told us, shared with us, and, I mean, it's such practical information. And it – it just makes sense. So, I appreciate the manner in which you presented.

Now we'll give you a trick question, okay? Actually, Jim, there's one on monitoring an audit, but I'm going to wait until you get into your spiel and then I'll – I'll punt that one to you. Jim, you referred to the tax credits, and as a nonprofit, we are exempt from taxes. Were you referring to individual tax credit on 1040s or something else at the corporate level?"

Jim K.: In – I believe it started in 2010 and will expire in 2014, but you can also go back and file a 990 – amended 990-T. It's a tax credit, which means you don't have to have paid anything in. We have – if you qualify – and I don't want to get into the qualifications. This is not my arena. But if you, as a nonprofit organization – it's based on your average number of employees and the pay per employee, and there's a calculation that needs to be done.

You can request a credit on a – using a 990-T, which is 990-Taxable, in order to retrieve a credit even if you never paid a dollar in. You don't have to pay UBIT in order to get that back – unrelated business income tax. It's – it's a credit, and so it can come back. And we've had a lot of nonprofit organizations, smaller ones specifically, that qualify for that credit and they had – they had no idea that it even existed.

Ann: So – so you would recommend that this person asks their auditor?

Jim K.: Ask your auditor or the person who's preparing your 990, and if they say, "I'm not sure. I have never heard of that," then you want to... Don't stop there. Pursue it with somebody else. Get someone

else in town that can help you with this because – you may not qualify, but if you can, it's well worth it. And – and I brought that up more as one of those things, again that value-added, that your auditor's looking out – even though they're independent, they're – they want to help you when it comes to those types of things.

Ann: I think the next one is a relatively simple one to answer, but I appreciate the person's attentiveness. They were listening and wanted to make sure they're going to do the right thing. "We're currently doing a three-year audit RFP process. We're considering extending an additional year with our firm due to a construction project that overlaps into the fourth year. Is that allowable?"

And in unison, I think we want to say yes. That's reasonable. It makes sense. And again, I think what you were talking about in terms of the rotation of the RFPs, at this point we're not talking about that they are requirements that are imposed on Head Start, but these are good practices that governing bodies and management staff need to take into consideration.

Jim K.: That's correct.

Ann: So with that, we're going to transition. I know people are saying, "No break?" Well, sorry audiences. We know that you can go take a break, but we can't. [Laughter] So we're going to transition – and I do want to say to – to the folks in the field, as we put up the next several slides, you'll notice that the density in the text has increased exponentially from Jim K.'s presentation.

And when we were preparing for this webinar today, I did say to my colleagues, Jim and Belinda, "Boy, when we get to you, we're stepping into the weeds." Belinda said, "It's not such the weeds; it's the garden." But what – it was important for us to create a permanent record. Yes, this is getting more dense, but we couldn't put any less on a slide and have you take it back to your grantee, use it for training, without knowing that the information you had was complete and it was exact.

We don't want to give you some bullets in this part of the presentation and have you say, "I wonder what they meant," or "I wonder what regulation that's associated with." I think Jim's you can take – Jim K.'s, you can take that presentation right now back to your board and I think anybody in – in top management could provide that training and walk them through it. So we're hoping to achieve the same thing here with a little bit more text.

So with that, I'm going to turn it over to Belinda.

Belinda: Well, thanks, Ann; and Jim, thank you so much for a really strong foundation to – moving into our discussion of a little bit more of the Head Start specifics of the audit process. And just be aware, there is an IM that came out actually earlier this month that requires grantees who are receiving their new five year grants to participate in an audit webinar of this type, and this webinar today does meet that requirement.

So, we'll go ahead and start talking about the audit process and how the audit supports effective fiscal management in programs. And again, we have one of those heavy, text-dense slides, but we did want to be sure that we included the actual information that you need and that we also provided you with citations for where you can find information if you want to go back and review it in more detail.

It's important to just recognize that all grantees are required to have effective fiscal management systems, and that's to maintain accountability for grant funds and to oversee property that's purchased in whole or in part with grant funds. And the governing body of the organization is fiscally responsible for the organization. So throughout our discussions today, it's important to recognize that the governing body needs to be heavily involved in the audit process, and we'll point out some specific areas as well.

And so, the single audit will really tell you how strong these fiscal management system elements, policies, and procedures that you've developed are and how effectively they're being implemented, as well as how well they're being documented.

And so at this point, we'll move to the next slide and talk a little bit about just what is the general purpose of that single audit. And those general purposes really are to make sure that the grantee is in compliance with grant requirements – and for Head Start and Early Head Start grantees, those requirements are in the Compliance Supplement that's specific to Head Start grantees – as well as the basic audit requirements that Jim discussed earlier in our presentation.

The financial statements will also be reviewed for their accuracy. And generally, the audit looks at the overall financial system and how it maintains accountability for funds and property and whether it's operating effectively in terms of consistency and the adequacy of documentation. I'm going to turn it over to Jim to talk a little bit more about single audit basics.

Jim B.: Belinda, the Single Audit Act came around in 1984. Before then, federal agencies were individually auditing grants. So you might, in your agency, have 10 or 20 different auditors coming through. The intent of the Single Audit Act was to rely on one single audit done by your auditor who would understand the compliance requirements of each grant.

I'm going to dwell for a second on that second bullet. When we ran the numbers and we looked at Head Start grantees, we found that almost all Head Start grantees would need to have a single audit because of the average Head Start award size being well in excess of \$500,000. And even those smaller awards, they go to organizations that tend to have other grants. So what I would urge, if you're in the audience and you feel like you may not need an A-133 audit, to circle back to your Regional Office and talk to your program specialist; talk it through.

In the way of introducing terminology, the Single Audit Act is a law from 1984. -133 is – is an OMB, Office of Management and Budget, circular. It's the regulations implementing the Single Audit Act. So for this presentation, we'll use single audit and A-133 interchangeably. The next document, the Compliance Supplement, is a document produced each year by the Office of Management and Budget. It's 1,600 pages long, but you don't have to read all of it. It has some – some general requirements that apply to all grants and then sections that apply to individual grants. Finally, the Single Audit Clearinghouse is an entity under the – the Bureau of the Census.

That is the first step in the federal government: that your audit's completed, the audit gets mailed or emailed to Jeffersonville, Indiana, and the evaluation process starts there.

Belinda: Thanks, Jim. We're going to talk a little bit about where information from the annual OMB A-133 audit fits in the larger picture of fiscal information. And when the Office of Head Start looks at grantee fiscal strength, there are some basic sources that are relied on, and one of those basic sources is that annual audit.

A couple of the other basic sources for evaluating fiscal strength are certainly the monitoring reviews, the fiscal evaluation of compliance that takes place. And information that's gathered during the triennial monitoring review is an important source of fiscal information. And in addition to that, fiscal reporting, particularly the SF-425s that are done semi-annually, annually, and a final at the end of the fiscal year, provide important information along with interactions with Regional Office staff and other information that the grantee submits.

It is important to note that most of the information that OHS relies on is – is periodic and after-the-fact. So monitoring reviews take place and they look back at fiscal compliance. The audit is looking back at the prior year. And even the SF-425s are looking back at prior periods. And so, really this gives the opportunity to look back at fiscal strength, but the entity that can and maintain fiscal strength is the grantee. So these sources of information are very important to the grantee and need to be understood not just by management, but also by the governing body and the Policy Council as well in terms of whether the organization is really meeting its fiscal goals and objectives.

And so, what's – what's really important for grantees is the information that's noted on this slide, but also the real-time information that a grantee can gather internally to determine if its fiscal systems are fully and consistently utilized, if they're supported by adequate documentation, and if they're really being utilized in support of identified program goals and objectives. Jim?

Jim B.: On the next slide, audits and monitoring reviews, I'll focus on that second bullet point on the left side.

Ann: You better hear my question first.

Jim B.: Oh, please go ahead.

Ann: This is the one that came in early. So if you could... So that – the person writes, "Explain the need for both an annual audit and a triennial fiscal review. Some of the processes seem to be duplicated." There you go, Jim.

Jim B.: Well, and I think we talked about at lunch that there is a great deal of overlap between the Compliance Supplement, which lists the requirements, and our Monitoring Protocol, which is kind of a series of questions that work – walk you through those requirements. And indeed, there are overlaps between the types of findings.

And Jim, at lunch you asked, "Is it possible that a monitoring review will find something that was not detected in an audit?" And the answer is yes, so there is relevance to that. And I know – well, I assume it helps our client, the Office of Head Start, in identifying risk with grantees.

So on that second bullet point, to focus on independence for a second. Jim talked a little bit about the government auditing standards, the YellowBook by the GAO. And if you – if you were to read that, you could read 35 pages on independence – a lot of different scenarios. And, you know, some of them are pretty commonplace and understandable; like if Belinda and I had a family relationship, you know, it would not be appropriate for me to be Belinda's reviewer – auditor, rather. That would make sense.



Something that Jim alluded to during his discussion was that the auditor should not prepare the cost allocation plan. And I think that falls under what GAO would call the self-review threat, the idea that if you're the auditor, you can't – you cannot audit your own work because you can't be independent with respect to your own work.

Another area for this is bookkeeping. Back in kind of the older history, it might not have been uncommon for auditors to do a significant amount of year-end cleanup work. The expectation today is that auditees are independently capable of doing that work, and even getting to the point of having GAAP financial statements at the end of the year. So the expectations have increased over time, and some of the things that your auditors might have done in the past, they don't do anymore.

Ann: So making – if the auditor were to make 92 adjustments in my statements, that would be a little bit suspect?

Jim B.: Well, I could defer to Jim on that. I would expect to see some kind of material weakness perhaps.

Jim K.: Right. It would... Yeah, that would probably lead to some type of finding of inadequate ability to – to handle the accounting records.

Jim B.: And I'll go to the next slide, please. We've talked a little bit about the OMB Compliance Supplement, and I mentioned that, you know, it kind of trees off in two directions: one are general requirements that apply to all grants, the other section are grant-specific requirements. So we have a section, for example, of Head Start-specific requirements.

I would say that almost all of the fiscal staff watching this would be familiar with this requirement, that costs must be reasonable, it – it must meet the prudent person tests, it must be ordinary and necessary for running the award. And this requirement comes out of the cost principles. And if I have a Head Start grant or a Department of Energy grant, a Fish and Wildlife grant, that requirement applies to all types of grants like that. So, that's a general requirement.

Belinda: And Jim, is it also correct that grantees are required to have a written fiscal policy or procedure that indicates how they'll apply those cost principles to their various expenditures?

Jim B.: That's an interesting point. For nonprofits – nonprofits are expected to have a written procedure that they follow to determine that costs are allowable, allocable, and reasonable. The focus of monitoring is a little different. We pull individual charges and we look at them to see, does this seem reasonable? On its face, is it a reasonable charge?

I'll skip to the next slide, please. And – and this is from the grant-specific requirements in the Compliance Supplement. So the Office of Management and Budget each year goes around to the various funding agencies – "Do we have your latest grant requirements?" And there's a negotiation process. They want to make sure that they're picking up the material requirements, that it's not something that's already a general requirement.

And this is an excellent tool. This part of the Compliance Supplement is only 11 pages long. So if you're discouraged by the 1,600 pages, maybe you'd want to just look at this. And – and – can you go back for a second? That kind of gives you an overview. This is what the Head Start program is about.

If you don't know anything about the Head Start program, you can start from here. If you were, for example, an auditor looking to bid on a Head Start program and you did not know anything about it, you could start by reading this. And who gets Head Start? And what do those services look like? What are the service delivery options? Now, could you please advance to the next slide? And so, this is an example of a grant-specific requirement for Head Start.

Belinda: Jim, before we start that, it seems to me that the Head Start Compliance Supplement was recently – fairly significantly revised this last year, and I think it has, just within the last week or so, been made public for the upcoming audit year. So if you've looked at it in the past, you may want to look at it again. And when you're developing that request for proposal, this would be perhaps a really important item to include; that the auditor be familiar with what's – what's in this Compliance Supplement.

Jim B.: Yeah, that's a fantastic point. In this case – and this is in your area of specialty – in the 1990s, the Head Start Act was revised. It allowed for properties to be purchased or renovated using Head Start funds. And so, there's some new requirements that go with that. And the requirement is that the property cannot be sold or transferred or otherwise encumbered or subordinated without prior approval of ACF.

And this is a point which – I hadn't thought about it when we first developed these slides, where the general cost principles are a little different than the Head Start Act. Because in the Head Start Act in the cost principles, you'll see, well, interest is usually allowable as an expense. In the Head Start Act, you'll see interest is allowable, but only when you come in for that prior approval on the property first.

And if we could go to the next slide, here are some questions – and I apologize for the tiny font size – from our monitoring tool. And the monitoring tool is publicly available. The grantees are certainly invited to look at it. And you'll see the questions in our monitoring tool are similar to the requirements that are set out in that Compliance Supplement.

So, the reviewer's going to have to answer questions about a specific building. Were federal funds used to acquire or renovate this building? If yes, is this building subject to a mortgage? If yes, can you show us a written subordination agreement? So that's kind of the interaction between the – the two documents – between the Compliance Supplement and the monitoring tool.

Ann: And I think, Jim, the reason – you know, people say, "Well, if they deal with it in the Compliance Supplement, why are you worrying about it in monitoring?" And I think that the reality is that we have identified this as one of our higher risks within Head Start. I think we could all take a look back and say, you know what, when – when the legislation was first passed that you could use funds to purchase, mortgage, pay interest with prior – you know, as long as you've had a 1309 application approved.

I'm not sure that we were all in the spirit of tracking and managing those real estate property transactions. So I think when we identify something as high risk, not only are we wanting auditors as part of the A-133 to pay particular attention to that special requirement, we are also concerned. And if we have another opportunity in a proactive way to make sure the grantees are managing and conforming with those requirements, that's good. I mean, I think that that's prudent on our part.

So again, I think these are areas, when you see them in monitoring highlighted and they say they're in the audit, it is for a reason because we know that's an area where there is some vulnerability.

Jim B.: And we went through that process about a-year-and-half ago. We said, "Well, these are the big significant risks."

Ann: Correct.

Jim B.: "These are kind of the – the areas where we get a lot of monitoring findings." And we decided, "Let's focus on those areas. Let's make it shorter, easier on everybody, but still try to pick up the big risks."

Ann: And I have to say, Designation Renewal, where we have grantees re-competing, you know, we – we're moving to five year grants. This whole issue of having your property in conformance and having titles and... This is – this is becoming even, I think, an area of more heightened concern, because if a grantee is ending and a new one is taking over, all that transferring of properties, the disposition, that all becomes complicated if people haven't done their business and conformed with the regulations up to that point.

Jim B.: At the very least, we want to understand, what is the federal interest in those buildings and also school buses and other huge pieces of equipment?

Belinda: Well, thanks, Jim and Ann. And you're absolutely right. Oftentimes, facilities are the single largest long-term asset that a grantee holds title to, and so it's certainly important to look at how they're being managed and what are the associated risks. And Jim, you gave us an example from the Protocol that's used for triennial monitoring and how it looks at property, and there is a little bit of a difference.

These are some materials that were part of the partnership that the Office of Head Start had with the AICPA Government Auditing Quality Center (GAQC). And that was back in October that we actually had that conversation with auditors and really learned that auditors weren't maybe as aware of some of the Head Start-specific requirements around property and inventory. But if you are working with a new auditor, or even your existing auditor, you may consider requiring that they go back and take a look at those webinars. Those are archived on the AICPA website and they're available to the public at no cost at this point.

But really, what we can see here is – the Protocol, when Jim showed it to us, had some fairly prescriptive questions and some fairly prescriptive document requests. And the answer was if you say yes to one thing, then another thing happens. And so, it has a definite bent toward looking at compliance in a somewhat pre-determined way. The auditor's really looking at what kinds of risks are associated with this compliance area.

And so, it's really a much broader level of inquiry, even though what you're seeing on the slide shows that it still comes from our Head Start – either grants management or our specific Head Start Performance Standards. But this is really looking at risk from sort of a multi-faceted standpoint. So here we're looking at property as a whole, so we'd be looking at equipment inventories, we'd be looking at insurance, facilities, activities that might be covered by 45 CFR 1309, and then those associated requirements, whether any property had been purchased, where permission was required.

On the next slide, we're going to see just even some more ways that property risks get examined. But essentially, that auditor is looking at that area of risk from multiple perspectives to determine whether

there's a risk that there's a lack of compliance in those areas. So it's really, in some ways, assessing the risk of not being compliant, whereas the Monitoring Protocol determines compliance.

Jim B.: That's – that's a good distinction, because the Monitoring Protocol is very transaction driven. You know, we will identify a facility and we'll walk it through the process. And based on these facts, we would expect this compliance to be there. And we're less – well, we're relying upon the audit because the audit's done things in a very kind of risk-based and statistically supported way, whereas on the Monitoring Protocol, we're just – we're looking at just a handful of cases to verify that the system is working the way we think it is.

Oh, that's me.

Belinda: Yeah.

Jim B.: So I pulled together this visual to – as a way of thinking about fiscal compliance. And I would start at the top and move clockwise, and think about the need for qualified and trained accounting staff, for procedures that drive compliance, and for things to be done in a systemic way – you know, consistent implementation of procedures. We find reporting to be one of the key systems in all of this. And the Monitoring Protocol looks pretty hard at the reporting to Regional Office and to the reporting to the payment management system.

In terms of a system for assessing compliance, you move into ongoing monitoring, which is a way of periodically checking in and making sure, "Do I understand what I need to comply with and is it – is it actually happening?" Communication becomes an important part of that. Are your program directors informed on the fiscal side? Is your executive management informed? Does your board have the information that it needs to make key decisions? Management oversight, board oversight... I think, Jim, you – you emphasized this. This is really where the buck stops for the grantee. The board has ultimate accountability.

And then we talked – Belinda, you talked about a couple of pieces that happen infrequently. Very valuable information, but sometimes it's going to be well after the fact that you get this annual audit and this triennial monitoring review. So there's a risk in that, that you're going to get feedback, but the feedback is so delayed that you could have made the mistake over and over and over again. That's why the earlier parts of that circle become so important.

If you're getting findings off your annual audit and you're getting findings off the monitoring report, I think it really becomes incumbent on the grantee to understand the root cause of those findings, to go back and see, well, is this a staff training issue? Is this a procedure issue? Is this a weakness in our ongoing monitoring? Grantee organizations have limited resources, and I think it becomes important when you're doing that assessment, where did – where was the system soft? Where did the system let you down? And focus your resources on that area.

Jeannie and Belinda: Jim?

Belinda: Go ahead, Jeannie.

Jeannie: I really like that graphic, but it makes me immediately think about – we're really just talking about one system today, and that's the financial system and the different puzzle pieces there. But it links

up; you could have some other circles connected to that, to program service and HR and IT. And all these things are certainly connected. And I think the monitoring process really gets at those other things too, whereas sometimes the audit, you know, doesn't cover all those. And I think it's worth remembering that all these systems are interconnected.

Jim B.: I like the puzzle pieces because, especially if you're new coming into an organization like this and, "Oh my goodness, there's so many compliance requirements." Well, it's not just one piece of the puzzle. It has to be built in to all of it. And I like the idea of the interconnecting system.

Belinda: Well – and before we move into the content of the slide that folks are seeing right now, I also want to emphasize what I think was important in, particularly, fiscal information, and that's communication. You know, those of us who work in the fiscal world all the time have become familiar with the terms that come up during an audit and – and understanding what financial statements are intended to convey and where the numbers may tell us that something is out of line.

But that information isn't intuitive to a governing body. And it's – it's important – I mean, we certainly have some expertise and are required to, by the Head Start Act, on the governing body, you know, in terms of an attorney and someone with fiscal expertise who can maybe help understand that information. But there is a strong responsibility to consider how is the most effective way to communicate fiscal information so that's its real meaning and the programmatic implications can be understood by the governing body and by any other users of that information.

So I think that's a really important point, as well as the concept that certainly many of the things that are – that are accomplished with children, like school readiness, are data informed. And governing bodies need information so that they can meet their fiscal obligations that are very data-based. And so, by taking all those elements and communicating them effectively to the governing body, you set that platform for them to do their fiscal responsibilities effectively in a really well-informed way.

Thanks, Jim, for – for that visual. That was really helpful.

On the next couple of slides, we're going to take a look at the multiple references to audit requirements that are in the Head Start Act and in the Head Start Performance Standards. And there are even additional references in the grants management requirements, which are similar to those that you're going to see on the screen. But this very clearly sets out that it is the responsibility of the governing body for the legal and fiscal administration and oversight of the Head Start and Early Head Start program, including selection of that independent financial auditor.

And I think there's some important language here that talks about that auditor, who shall report all critical accounting policies and practices to the governing body. And I think we've heard several times that this information really needs to come from the auditors, not through management, not in the sense of just being distributed to the governing body, but that it actually be presented with an opportunity to ask questions and provide explanations.

So the governing body needs to be heavily involved in the annual financial audit, and not just selecting the auditor and reviewing the audit and its – its results, but also monitoring any actions that are needed to correct audit findings. And so, there's a requirement that the board also be involved in those activities. It is important to also note that that – the information has to also be shared with the governing body, as noted earlier, but also with the Policy Council.

And there's also a requirement that within 30 days after the completion of that audit that a copy of the audit, including the management letter and any findings that relate to Head Start, be submitted to OHS. And that would be to your Regional Office, as well. So this is in addition to the requirement that Jim mentioned earlier, and we'll also talk about – that the audit be submitted to the Federal Audit Clearinghouse.

I – I know Jim would tell us – I think that a fairly common finding in monitoring right now is that, when grantees are doing their annual reports to the public, they're not including the required financial audit results. So your audit isn't just an internal document, but it also needs to be something that informs your annual report to the public.

Again, we mentioned earlier, any organization that has a going concern finding on its audit is required to participate in a competitive process for its five year funding and is also required, if such a finding is made, to report that finding to the Office of Head Start. So I was almost surprised, even though I was aware of these requirements, by the multiple references to audit and the extent to which it's clear that the governing body needs to be involved in that audit process.

Ann: Would it be appropriate – and I – I was thinking earlier, before we started the webcast, that, Jim K., you were talking about reminding us all that still the majority of nonprofits rely on volunteers who are often not – don't have the skills or the understanding of what can be fairly complex fiscal matters. Would it be appropriate to put in the RFP that – and maybe this is not the auditor's job, but let me just try it out – that the auditor would provide, before he – before he provided the briefing on the results of the audit, that he provided a training to board members if – you know, for those that maybe didn't understand financial, to provide a training so they had some foundation for when you were reporting out the findings?

There was a – you know, some knowledge – some basic knowledge of what the heck you were talking about. Is that appropriate or do you see that as a non-auditor thing that and the grantee ought to just go [Inaudible]?

Jim K.: No, I think it's very appropriate. It's not a part of the normal audit process, so there will probably be a cost to that. However, if the organization – I – I always say to every organization that I audit that we will – as part of this, we would like to present this to the board. And some will say, "No, that's not necessary." And so, if – if they do – and I can't force myself upon them – but if they do, I always – ask me to come, I always try to make it a bit of a teaching time too. But again, that's – that's just the way I do it. Not everybody does it that way.

But if you wanted to be more purposeful than that, I think you could, but you'd – you need to be very clear in your RFP so that you're getting a proposal from every firm that includes that and not just speak that to one or two that you're interviewing.

Belinda: I think that's a good point on the request for proposal, Jim. And it also supports, although it's not an audit-specific requirement, there is a requirement in the Head Start Act for grantee obligations that talks about providing the governing body with all necessary training so that they can fulfill their obligations. And given how unique that audit process is and how important it is, that would be something to focus on in terms of how are you going to create that knowledge base for your governing body. That's a great point.

Jim K.: One last comment, too. As we were talking about that, the auditor might be very equipped to do that and they might have a great presentation, but if those receiving it are resistant to it, then it's not going to be very effective. So that becomes – it's a two-way street. The auditor needs to be able to do that if that's what's requested, but those who are listening need to be really motivated to want to learn and – because that is part of their – their overall fiduciary responsibility.

Ann: And not that we would ever want to scare board members, but they carry some liability here, do they not, these days?

Jim K.: Absolutely.

Jeannie: And Jim, I would just say that your comment early on about the executive director really setting the tone for how the staff approach the audit, I think there is definitely the same – the same spirit for the executive director setting the tone for the board. If the executive director really emphasizes that it's important for the board to get this kind of financial information directly from the audit firm, I think – I think that helps a lot. And I think that we're seeing more and more that that is really best practice expectation moving into – this is going to be part of the high-level accountability we – we're all going to live with moving forward.

Jim K.: Right. And I don't think you need to stack your board with 100 percent financial people. I think they need to be mission-minded and understand the organization well too, but one or two key members of your board that have that expertise and they can bring that to the table can be very effective. And they can help interpret for those that aren't. So it's not like stacking it 100 percent, but it is important. If you have zero financial – financially sophisticated or astute people on your board, you are missing an important element.

Ann: And I think that's why, in the last reauthorization, they put the requirement in that there be someone with fiscal – fiscal expertise on the board.

Jeannie: And I would just reiterate, you know, we talked about a number of community action agencies out there, and certainly there are board requirements to be a community action agency that you couldn't require you know, everyone to have – be a financial expert, but you want that balance. And, you know, the board is responsible for finance, but they're also responsible for good quality programs and for meeting the anti-poverty needs of communities. So we have to take all those into consideration, which makes the job a real challenge, and I think we all appreciate that. But it's also the beauty of this work, I think, and why many organizations can really achieve robust outcomes.

Belinda: Great. So just to, you know, take us back to the process that Jim Krimmel talked about earlier in our presentation, we got some great information about how to plan for the audit in terms of: How do you select an auditor? How do you get ready to conduct the audit? And we're going to focus more now on how do you really utilize that information at the program level?

So again, the important issue is certainly that the audit gets done, it gets done in a timely manner, and that it be a clean or an unqualified audit, but more importantly that that audit information really becomes part of an effective plan on the grantee's part to use their fiscal resources effectively to support program goals and objectives.

And so just to recap a little bit the information from earlier, in step 1, really recognizing that training is important, particularly for those governing body members who are participating in the audit process. This is certainly a place where, as Jim suggested, you could draw on the attorney or the person with fiscal expertise on the board who might be able to facilitate good governing body participation in this process.

There is the option of setting up an audit committee, and that can sometimes be helpful to manage the RFP process. But it's also important to remember that that audit committee cannot substitute for the full responsibility of the governing body that's required in terms of meeting their obligations and is required in the Head Start Act as well. And so, really, one of the things that, as a grantee, you want to think about when you plan for the audit is also, how will I plan to involve the governing body? How will I plan to involve staff and make sure that they're available? What will I do to meet my program's specific requirements, as well?

Let's take a look at step 2, which is preparing for the audit. And I think we've heard some great ideas about, you know, what would we include in the RFP to make sure that we get really highly qualified candidates who are prepared to present information to our governing body and really have some understanding of the unique nature of our program, type of organization, the size of the organization, and its level of complexity.

And that auditor selection should be done using the procurement procedures that are already in place in the organization for selecting that kind of professional support. So make sure as you're getting ready for that audit, especially if you're going to go out to bid or maybe you haven't done that for a while and you're thinking you should, go back and take a look at those procurement procedures in your fiscal policies and procedures and make sure they're complete and up-to-date and are really working the way that you want them to.

Then I think Jim emphasized how important it is to gather that required documentation, that most of the auditors will provide you with a list or kind of a checklist or a kit that tells you what you need to do to be ready for that audit, and – and that it's really important to follow those instructions, be ready, and then to have that pre-audit meeting. And it's like many processes. The more effective the preparation, you know, the more – the more efficient, the shorter period of time, and the higher quality that the product is going to be. So it allows that the auditor gets what they need to do a really good audit, and it allows you as a grantee to make sure that you get all of that value-added that we've talked about today from that audit process.

The final step, which with particularly Head Start grantees can be, you know, fairly detailed, is really involving that governing body in the receipt and the comments on the draft audit and management letter so that things are not coming as – as a surprise to that governing body. Certainly the presentation of the final audit, which best practice would be to have that presented by the auditor with an opportunity to ask questions. You know, don't forget that you're required to share those audit results. In the end, you'll report to the public.

We'll also talk a little bit more later about, in addition to that audit coming into the program and being shared internally and in the annual report, it also has to be submitted to the Federal Audit Clearinghouse where there'll be a process to resolve any audit findings. If there are any audit findings that need resolution, the governing body is required to participate in that process as well. If there are



any going concern findings in the audit, it needs to be reported to the Office of Head Start. And in all cases, to use that audit information to really plan for effective fiscal management.

Okay, Jim, I'm going to turn it over to you to talk about just some – some elements of what governing bodies and managers will be looking for in those audits.

Jim B.: In terms of the audit opinion, which I believe is on the next slide, Jim K. already went through a lot of these opinions, so I don't want to double up on that. I would echo my strong support for – to have the auditor on-site to actually present the audit report to the board. I think there's an opportunity for some real meaningful interaction there. Without boring you with the details of what languages and which type of audit opinion, because some of that language is arcane and – well, from my own perspective, I think it has meaning only to auditors. You know? [Laughter] I don't know if you'll agree, Jim.

Ann: I think for lay folks, to couple "unqualified" and "clean" just doesn't kind of do it for us. We're always trying to figure out, if you're unqualified are you clean? [Laughter] Do you know? It is hard for – for folks not in your business to really get these and – and sort of just remember what implications they have.

Jim B.: And my suggestion – my take-away from this, because part of the audience today are, you know, executive staff, board members, folks who are not accountants and don't want to be, I would suggest that – during that audit presentation, I would ask, "Well, is this a clean opinion?" And if it's not, then, "Is there something that we need to be doing differently to move towards a clean opinion?"

Jim K.: If you... In the new version of the audit report that came out this year, there's headings on each paragraph, and if you look at the opinion paragraph, it's labeled "opinion paragraph," if – it will say "in our opinion" as the first three words. If you see "except for" as the next one – if the next two words are "except for," then you know you have a qualified opinion. It's either "except for," like I said before, an accounting problem or an audit problem, and that will be explained in another paragraph. But "except for" means that you don't have a clean opinion. Otherwise, it's just going to go on, "In our opinion, the financial statements are presented fairly." And so, just look for those words "except for." Well hopefully they're not there, [Laughter] but that's a qualification.

Jim B.: And I think in most cases, the goal is to have a clean opinion. There may be some structural thing that prevents that.

Jim K.: That's right. There are... A qualification doesn't necessarily mean the end of the world. Adverse and disclaimer, that's a different issue; but a qualification – there can be a good reason for a qualification. We don't need to get into all those details now, but there are – there are some justifiable reasons, possibly, for a qualification.

Belinda: And so then, sort of on the other hand, if I get a clean audit opinion, does that mean, if I'm on the governing body, I don't have any other fiscal concerns with that report?

Jim B.: I'd certainly want to look at that balance sheet. And I don't want to jump some of the other slides, but I'd look at the back end of the audit as well.

Jim K.: Well, I had that question the other day from a client who said – we had a discussion about, what do we mean by unqualified? Does that mean we're – there's no concerns? That's not the way you want to interpret your audit opinion. When I say – when I say you have an unqualified opinion, in other words you have a clean opinion, I could be saying, "Your horrible, terrible numbers as an organization – you're really in deep financial trouble – are still presented fairly in accordance with Generally Accepted Accounting Principles. They're poor numbers. From a management standpoint, you have a lot of reason to be concerned, but you've at least presented them fairly."

So we're not – we're not making a judgment call as to whether you're a healthy company or not. We're just making a decision as to whether you've reported your numbers correctly. There's a big difference. So you could be in bad shape and still get a clean opinion, so be very careful with that.

Jim B.: But if those numbers are horrible enough, you may end up writing in your opinion something about going concern.

Jim K.: That's correct. That would be in a separate paragraph, but correct.

Jim B.: And that'll segue to the next slide. And going concern, this caused me to go back to the dictionary. A going concern is a business that functions without the threat of liquidation. So a going concern is a good thing in most cases.

Jim K.: The word "concern" can throw you off there; that's not what they mean.

Jim B.: However, if the auditor thinks there's a reasonable probability that the grantee may not continue in operation for 12 months, as you said, that going concern paragraph in the opinion is really a serious implication for a grantee.

Jim K.: And we're not saying when we – when we put that in, we're not saying, "You will not." We just say that we have – there's a reasonable possibility. And actually, we don't even use that wording. But we say that, you know, there is a concern that you may not continue as a going concern.

Jim B.: And I can appreciate there's pressures for you on both sides. You know, if you incorrectly include this in the report, there's a very adverse impact for the grantee. If you incorrectly exclude it, the folks on the funding side are you going to call you to task for that as well.

Ann: But – and I think, also, there's going to be added push-back now. And I don't... Having to re-compete is not an adverse action, and I think – but many grantees feel it is an adverse action. It is not an adverse action. But I can bet that any grantee, throughout the audit process, senses or now is getting an indication that there's going to be a going concern, will push back like crazy because they don't want that to then require them to re-compete.

So I think we would say to the – to the auditing field, you know, "Please don't push back," because I think absent something that is truthful that can help a grantee take seriously its condition is far better than having it hidden somewhere in a footnote that someone may never discover.

Jim K.: And I've had an organization that I audit that has had a going concern paragraph in their audit report for the last five years. They're still in existence. So their answer is not, "Well, see? We did make it." That's not what this is saying. This is not saying, "This organization will be out of business in 12

months." But there's reason for us to be concerned. That's – there's a big difference. We don't have a prediction as to whether it's going to go out, but unless they're making steps – significant steps toward turning the organization around, that will stay in.

Jim B.: And if I could skip to the next slide, question costs. And Jim, unfortunately, I'm also using the example of credit card expenses; probably because it's – it's the most common monitoring finding for us, both documentation of credit card expenses – that condition exactly that you spoke of, paying from the statement instead of paying from invoices – and also because it's a reporting issue. The Head Start Act requires monthly reporting of credit card expenditures to both the board and the Policy Council. So if I could give one shout out to the folks listening today, it would be to make sure that that reporting is in place, and that would be a way to avoid a monitoring finding.

So in – in the example that I had, you know, the – the auditor has pulled credit card vouchers, there were no invoices supporting the credit card vouchers. And I used the example, there were 11 vouchers totaling \$15,000. So there's a requirement in the cost principles – a general requirement that costs be documented – costs be adequately documented.

So from the compliance perspective, if there are no invoices, then the cost is not adequately documented. You could have used that credit card at a big box store, and we don't know – was it used to purchase diapers and formula or was it used to purchase something else that's completely unallowable? Without the invoice, we just don't know. And to echo what Jim has already said, the lack of controls around credit card purchases is a scary thing.

Ann: It's a slippery slope. And I think I look at the – the public reaction, too. I can think of a couple of situations, Jeannie, that I bet you're familiar with, where we might have had agencies that were multi-million-dollar agencies and an executive director made a stupid mistake. And it could have been \$10,000 or \$15,000, but all of a sudden – and I'm not saying totally unacceptable, but the risk was there.

And that might have been the only mistake, you know, the only thing that ever got uncovered, but the reputation of that organization based on that one stupid mistake – and I think the public has absolutely no tolerance for anything that's credit card misuse, because that's taking our taxpayer money and abusing it and not using it for the kids. And I think – I think if programs consider those kinds of risks, then the internal controls around those things are going to get tighter.

Jim K.: Within the last month, we had a serious discussion with one of – one of our audit organizations where the executive director, his particular credit card statement had zero documentation attached. And we said, "What's going on here? We've talked to you about this before." He then, based on our request, went and dug it out of his shoebox – wherever he had it – and brought it into the office. And we still continued to write them up saying, "This bill was paid. You might have it now, but it was paid when it was not attached."

And so, it's very important that all – and again, theirs were the top down also. The staff will follow the executive director's leadership on that. And you know, this is not nickels and dimes. A lot of organizations are using credit cards for very significant purchases, so these are – these are not just small dollars.

Jim B.: So to continue with that example, the finding might identify a dollar amount in it. That dollar amount would then be picked up on the transmittal form that goes to the Clearinghouse, and that's how

it enters the process. Those funds may be subject to recovery or disallowance. It's really a discretionary process.

Go ahead. I'm sorry.

Belinda: No, Jim, I just wanted to also add, for those smaller programs that are still in towns like my program in Nebraska was where they use open purchase orders at local stores, those should really be treated the exact same way as credit cards in the sense of having the adequate documentation, having the actual invoices, and having the internal controls to ensure that the same person can't decide they want to make the expenditure and actually make it and – and maintain the recordkeeping as well.

Jim B.: I agree. The last area we'll talk about are management letters, and we've already talked about the requirement to submit management letters within 30 days of receipt to the Regional Office. And in the hierarchy of things, you talked about material weakness and significant deficiency and deficiency, and management letter comments are more like suggestions. And I dug up a couple of them. "We think you should have a second approval on bank reconciliations." "We think you should have a month-end closing checklist."

And these are things – you could probably do without these things. Not having these things would not cause you to have a finding. However, I think there's a lot of pressure on recipients to correct these things and make sure that they don't appear again, and maybe this idea that a management letter comment is a gateway to a future audit finding. Fix it now while it – before it becomes a finding.

Jim K.: Also, our place where auditors will put just suggested improvements to the organization that don't rise to a deficiency that needs to have that type of attention, but it's just a good operational – again, value-added. How can we make this organization run more effectively and more efficiently than – than something that would cause a finding?

Jim B.: And I don't think the Office of Head Start treats that in a punitive way. If a recipient gets a management letter comment and responds to it and improves its system, I think that's considered a positive – a positive thing.

Ann: It also could be a way of identifying and requesting a need for training and technical assistance.

Belinda: Okay. Thanks, Jim. We're going to just transition a little bit to what would we do in terms of, if I were on a governing body, what kinds of questions might I want to ask the auditors when they present that audit report? Let's take a look at those questions on the next slide.

These are just some ideas for governing bodies, things that you might want to consider asking or having even as a set of established questions that you might want to ask those auditors when they present the report in terms of, how cooperative was the management team in the audit process and were they able to provide all the requested information?

Asking about whether your fiscal policies and procedures are comparable to other kinds of organizations that are like yours. Asking the auditors, "Are there any situations that you looked at that might result in a disallowance of funds?" So that would be, maybe, questioned costs that have an associated disallowance with them.

I think another important issue is, if something has appeared on a prior audit and it's continuing to appear on the audit that you're looking at, then has the management team implemented changes that were suggested in prior years? And if I'm a governing body member, I'm probably going to want to see at least the prior year's audit, and maybe even a couple of years of previous audits, when the current year is being presented so that I really can look and say, "Well, why was this number like this last year and now it's different?" or, you know, "It looks like we used to have this grant and now we don't anymore. What happened there?" so that you can maybe look at that kind of continuity from year to year and what might have changed.

And then just the broad question of, "Was there anything in all of what you looked at in the financial statements or financial management that we should know about as being fiscally responsible for the organization?" And then, just the kinds of things that were mentioned that might be – maybe even not included in the management letter but just helpful suggestions for improvement of the fiscal policies, procedures, or operations of the organization.

And these are all questions that a governing body could appropriately ask an auditor in the context of – of presenting the audit to the governing body. And, Jim...

Jim K.: Belinda, one more thing maybe to add to that, or another way of interpreting that last point would be, is there anything coming down the pike, so to speak? Is there any Head Start or OMB changes, IRS issues that we should be preparing for so that we're not caught off-guard when it's already been in place halfway through our year and we didn't know about it until the end of the year?

Belinda: Great point. Thanks, Jim.

Jim B.: In terms of the basic audit report analysis, I'm going to focus on the third bullet point to talk about the schedule of repeat findings. That's towards the back of your audit report. I recently attended a training for new grant staff, and they were told that – that if they would only look at one thing in the audit report, that would be considered the most important thing to look at. And it makes sense because it's really reflecting, is this organization absorbing the results of the audit? Are they moving forward, correcting those findings? Is this organization maturing?

The second bullet point is important as well. How long did it take to crank out that audit report? One issue is to think about the reporting system. Why – why would it be taking the full nine months to get audited financial statements? Are there significant adjustments that have to be made? Is there just way too much bookkeeping that has to happen at – after the end of the year?

But also I think – to think of that, you know, compliance wheel, that if it's taking you that long to get the feedback from the audit, how long is it going to take to incorporate those audit results? If it's taking you the full nine months, almost certainly you're going to have a repeat finding because you're already – on the calendar year, you're already into October. The likelihood of having a successful fix by December 31<sup>st</sup> is rather slim.

Jim K.: You were very nice, Jim, in the way you presented that – that you put all the blame on the organization. But if it's – if it's taking nine months, it may not be, but it could be the auditors. They're too busy or they're not giving it the right attention. And so, it's worth getting to the bottom of it and trying to find out why.

Jim B.: That's – that's a good point. I hadn't really thought of that. In my personal experience, I haven't had that.

Ann: Can I ask a question? In the world of auditing, if you see these repeat findings, is there ever a time when that repeat morphs up to something more serious just because it's repeat?

Jim K.: Well, you can't move something from a significant deficiency to a material weakness because it's being repeated. That's a materiality issue. But, repeating it is basically all we can do. And so, if it's in... are times as auditors where – not to bust on the grantors, but there are times as auditors where we will repeat a finding and it's not – there's never anything done, so we end up being the heavy and not – not the grantor. So there is times where we wonder, "Is anybody looking at this?" it – but we all have to participate in it. But no, there is not a way to – to make it louder, so to speak.

Jim B.: So you may have identified a questioned cost and then that becomes the subject of a repeat finding. There's been no action taken on that questioned cost. Is that a scenario?

Jim K.: Right. Or even a – even, you know, a cash management issue or some other type of compliance issue that doesn't have any known questioned cost related to it but that is not addressed. So you know, there are times that that happens.

Jim B.: On the financial statement analysis, I think this is an area that we could obviously spend hours talking about. And Belinda, you've mentioned increasing debt levels. That's certainly something that we see out in the field when we're doing monitoring, and we do try to understand why that might be happening. I – I wrote down a few bullet points.

We like to make sure that a grantee has net assets, which we might also – in another world we would call retained earnings, the grantee's own resources. We – we want to understand how those retained earnings are invested. Are they tied up in – in plant? Does the grantee have adequate cash? Are they liquid? Can they pay their bills on an ongoing basis? So without deviating too far from the slide, I think there's a lot to be learned by looking at those comparative financial statements. Where were we today? Where were we a year ago?

Jeannie: And I think this is – again, the value-added that we've talked about is that when the auditor comes to give the report to the board, do they present some of that information? Do they do some of this analysis? I've seen auditors come and present at board meetings that have beautiful bars and – graphs and charts that really help board members to digest some of that. And I've seen auditors come and, you know, it's very cut and dried, and it – it doesn't really make meaning of the information. I think what we really are trying to do is make meaning of that report.

Jim B.: I think that's a great point because, first of all, the visual aspect. For me at least, it's easier to absorb it graphically or – or an illustration like that. And also, you and I might – the three of us might review financial statements and see, "Oh yeah, yeah, yeah," 10 different things. But for non-accountants, I think it's important to maybe focus on a smaller universe of data points, two or three things.

Jim K.: That's right. And one of the things you mentioned is looking at the cash. For instance, if you look at unrestricted cash and it is less than your deferred revenue – deferred revenue being funding that has been received but not used yet – then what you're in essence saying is you're spending deferred

revenue. The cash flow – that cash is going out the door. And if you were to stop that organization at that moment, they could not – they could not pay that back.

Jim B.: That might be an indicator that you're floating on federal cash.

Jim K.: That's exactly right. That's usually an indicator.

Belinda: And Jim, before you go on, I just want to remind our viewers that we do have a sample set of financial statements that are available that go along with this presentation that have some really helpful notes in terms of what to compare and what some of those meanings are. And those will be posted on the Early Childhood Knowledge and Learning Center website along with these slides when they're posted for viewing after the broadcast is complete.

Ann: Now you've just provided all the auditors with their training materials when they go work with the grantee, but I think those are terrific additions that will be posted.

Jim B.: To jump to the next slide, thinking about the grantee's revenue and expenditures. You will – you will also want to look at that on a comparative basis. Look at that year over year. And if your organization is in a negative funding environment, then revenues are decreasing. The question that we would be asking – or I would be asking is, "Who is going to cover those fixed costs?" You know, organizations have facilities. They have staffing costs that are not easily adjustable. If revenue are going down, what's the plan moving forward?

Ann: And I think – we know that several of our grant programs, there have been cuts or – and more cuts in some places than in others. So we do think that some grantees – probably a large portion of grantees – are really facing that decrease in – in funding right now. And I guess the question becomes – because, you know, Head Start funding, grantees have different fiscal years. And we – you know, we've got the federal fiscal year, but our grantees are funded – it could be January through December.

At what point, when you've done your cost allocation plan and that was your intent going forward for the next 12 months, and midway through you lose a significant portion of your funding, which is going to impact how you've allocated those fixed costs, is it – is it something that then the grantee's going to have to make that adjustment at that point when the funds were lost, which is creating a disproportionate allocation?

Belinda: I mean, I guess one of the things that the grantee doesn't want to do is arbitrarily change the cost allocation plan to reflect those changes in income. But to the extent that actual programmatic service changes have been made and staffing changes have been made... So for example, the grantee may, because they lost funding in one area, combine two positions. So maybe instead of having an ed manager for each of two programs, we now have an education manager who works with both those programs.

Well at the point where that shift takes place, then the cost allocation plan going forward for the remainder of the year would need to now reflect how that position was going to be allocated. So I – I think the answer is that you wouldn't want to make arbitrary changes to the cost allocation plan, but changes that are necessary to reflect programmatic accommodations that you've made because of that loss of funding should be reflected in a revision to the cost allocation plan.

Jim K.: Right. And then that would be followed up by a request for modification to the – to the budget, too. Because if those budget modifications aren't made, then we're going to be if we change our allocation plan without getting a budget modification. But the same thing happens if we get a new funding source. If we have a funding source, again, each organization, each federal agency wants to pay their fair share. So now there's someone else that can take a piece of the rent, piece of whatever, and so spread those fixed costs out. So – and we could say, "Well, it was good enough before. It's still good enough now." But that's not the way it works. We need to build that into that allocation plan.

Jeannie: And I guess I would just think about – you know, again, here's another example of how challenging the environment is today. You know, we just looked at this last year, and we had, you know, many cuts across federal programs because of sequestration. And – and a lot of those numbers weren't known until late in the game. And so, folks really have to be on top of their financials in every program, not just Head Start but CSBG and LIHEAP. And you know, it's all connected in many of these agencies. And you know, I really do appreciate that it's much more challenging than it used to be in many ways to manage a lot of this.

Jim K.: It starts with... I agree with that 100 percent. It starts with a really good allocation plan to begin with. Then the modifications aren't as challenging as if you have a poor one, and then you're not really sure how to change it. You know, a good allocation plan shows you what it really costs to run the program, allows you to prepare a good budget for the next year. So, it really – it starts with that good, solid allocation plan.

Jim B.: As we look at functional expenses, drawing from our monitoring experience, we want to look at unplanned equipment purchases. First of all, because approval is required before equipment is purchased, but also because we want to understand, where did the money come from that allowed for these unplanned equipment purchases? We want to focus also on facility costs, mortgage payments, building purchases, big renovations. Those are prior approval items as well under Part 1309.

We'd want to look at fringe and understand it, because there's really been a lot of upward pressure on fringe over the last few years and we want to understand how that's being managed. I would look at salary very closely, too, because Head Start is primarily a salary program, and that would be the obvious place to kind of make up for those multitude of problems that I've described. And we want to understand, is the staffing pattern in the approved application being adhered to? And if it isn't, then is the agency achieving the goals that it set for itself?

You mentioned maybe combining a couple of positions to save money. We've seen cases where organizations have reduced the number of service hours, unfortunately, and we want to understand whether that change in the scope of program has – is the agency still achieving the goals set forth in your application?

Ann: Well, and I think our director would say, "Are we – are you beginning to compromise the quality of services?"

Jim B.: The next slide talks a little bit about cash flow. I will tell you that in monitoring we do look at that extensively as well. We look at the aged payables listing to see whether there's a lot of Head Start expenses that are sitting out there unpaid for a long period of time. The expectation is that, since the Head Start award is available to be drawn down on the payment management system, that the funds are available to liquidate Head Start costs on a timely basis. So, we talked a little bit about how federal



funds might be used to float the organization. So that's – some of the testing that we do in monitoring looks at that.

Ann: Could I ask – this is actually a question that came in from the field. You talked about the time that – when you withdraw the funds and there are so many days in which to expense, and then I think someone said, "Well, it really – the expectation is it's within 24 hours of the end of the next – close-of-business day." But does the same – or what rules apply when it is a grantee withdrawing funds then to give – to forward those funds – advance those funds to the delegate agency?

So, I'm the grantee. I draw them down. So I kind of have three days. Is the three days getting them out of my system to the delegate? Or – and what rules apply to the sub-recipient? We could probably do a whole session on sub-recipient reporting, because I – I think there's a need for it, but in this case, do you have the answer? And if you don't have the answer, we'll – we'll go to the right source in the federal government and get it. But if...

Jim B.: Yeah, and we may want a policy clarification on that, because the practice we've seen is that grantees often draw working capital advances for the delegate agencies, for their sub-recipients. However, you would think that the cash management requirements that apply to the grantee also apply to the sub-recipient. And from a risk perspective, those little pockets of federal cash sitting in delegate agencies – well, in my opinion, that might be a bit of an unacceptable level of risk.

Jim K.: I believe that that applies to the sub-recipient as much as the primary recipient.

Ann: And I think... I heard "I believe," so we're going to get confirmation on that. [Laughter] Peter Thompson, if you're listening, we're coming after you for a policy clarification on that. But I'm actually glad that the person brought it up, because I think there is some, I think, lack of probably understanding in the field. And I think here, we're saying, "Yeah, we think it applies." And it probably does, but I think we need to – to confirm that because that would then speak to the grantee's ongoing monitoring policies across its sub-recipients.

Jim K.: One other note on the statement of cash flow because that was referring to the actual financial statement. Typically, most organizations do not prepare a statement of cash flows on a monthly basis. It's the first to the balance sheet in the statement of activities. But that is a yearly – at least comes as part of your yearly audit.

And what I always try to point out, if you look at the example, I'm pretty sure that – that you were talking about earlier, there's three sections in that statement of cash flows: cash flow from operating activities, cash flow from investing, and financing activities. Investing and financing are not your day-to-day things. That's the buying of equipment, the selling of equipment, the borrowing on a line of credit and paying it back. Those are not your day-to-day functions, whereas the operating activities are your day-to-day operating activities of the organization.

And so, if you look at that subtotal, that's just – it's probably about a third of the way down the statement of cash flows – if that's a negative number, that means your day-to-day operations is sending more cash out than it's bringing in. If that's negative for two or three years, you're going to have a real cash flow problem.

So that's another little highlight that you can look at and just bead in there. Because a lot of people say, "Well, as long as we have more cash at the end of the year than we had at the beginning of year that's good." Well, that's not necessarily – because if you borrowed it, that's not good. If you had to sell equipment to get it that's not good. So if you're looking at the operating cash flow, it's saying what your day-to-day operations used and brought in for cash flow.

Jim B.: And then in terms of analyzing the footnotes, I think, certainly, balloon payments are a serious consideration for our recipients. During the downturn of 2008-2009, there – there might have been some more restrictive borrowing requirements.

I want to bring attention to the fifth bullet point, the related parties bullet point, because this is an area where we're seeing significant monitoring findings and, because of the long duration of these related party relationships, the impact on grantees is very serious. And so, specifically, we're talking about less than arm's length real estate transactions, where the grantee is an occupant in the building, the building is owned by a company that's related to the grantee, this related company has no significant outside source of business. So it's – it's... Could we call that self-dealing?

Belinda: Yeah. Less than arm's length, certainly, I think we would apply it to that.

Ann: Is that the same as wheeling and dealing? [Laughter]

Belinda: I think less than arm's length is less positive than wheeling and dealing. [Laughter] I think all grantees are wheeling and dealing right now, but less than arm's length can be a problem. And as Jim mentioned, that's a situation where, you know, because of either business or personal relationships, you know, one organization has the ability to influence the decision-making of another. And that can be because they're sharing members of a board. It could be an overlap in executive staff. And it could be because they're financially dependent on each other so that they can influence the other company as well.

Jim B.: So if it's less than arm's length, it's as though the grantee owned the building itself. And their recovery on the cost of building is limited to depreciation or use allowance. No interest. And the position that's taken by the Office of Head Start is that if – to get that interest, they would – the grantee would need to come in and apply as if they owned that building. So, the numbers add up very quickly in this area. If you think you have a concern, you might want to bring this to the attention of your Regional Office to start working towards some kind of positive resolution.

Belinda: And I think, in general, the idea that there are related party arrangements always raises the issue of whether there's been free and open competition in – in that process.

Jim B.: And at the very least, even if it's not property, if a related party is providing management services or something, we want to understand that that transaction is based on cost, that there's no profit built in for the related party.

Ann: I think we have a couple of more slides, and then we have a couple of questions. And I bet our – our audience is beginning to nod. It's been a long – it's been a long three hours, but I hope that the information has been helpful. So why don't we go through the remaining slides and then we can take some questions.

Belinda: Yes, we just have a couple more slides; and this one is really just to say what happens with the audit, not internal to the program, but what happens once it goes to the Federal Audit Clearinghouse. And again, that has to be 30 days after the audit is completed or within 9 months of the end of the fiscal year, whichever occurs earlier of those two. And so when that audit gets sent in by the auditor to the Federal Audit Clearinghouse, there's a particular form that it goes in with. And the Audit Clearinghouse reviews it for its compliance and – and required documentation.

Now, the Audit Clearinghouse will accept a late audit, although a notice does go to the Regional Office to let them know that that audit has been submitted late. The Clearinghouse will not accept an incomplete audit. So if, you know, it's just simply not complete, doesn't have everything that's required, maybe Head Start is a major program that didn't get audited, they'll actually kick that back. That's another reason not to wait until the last moment to get that audit completed.

But once it's determined to be complete, it moves on to the National External Audit Review Center, or NEAR as it's called. NEAR is where the audit is reviewed to determine if there are any audit findings. If not, that's the end of that process. But if there are audit findings, then it goes into a formal audit resolution process that's managed through an actual system of resolution and tracking until the grantee is able to demonstrate corrective action that addresses that finding. And that process is done in cooperation with the Regional Office's support as well. And then once that finding is closed, the process ends.

And then just one other reminder of the importance of audits. If you haven't taken a look at it, there is an IM that came out in 2012 that addresses much of what we've covered today, though not in as much helpful detail, about choosing an external auditor that really highlights the importance of the audit in terms of really understanding overall program management and fiscal operations, its relationship to high-quality services, and the extent to which a high-quality audit also promotes a kind of transparency and – and promotion of public confidence – a thing that grantees are really looking for in today's world.

So, those are the last of the formal slides. And were there some questions before we have closing comments?

Ann: We do have a couple questions. And actually, I'm going to hand you – this question you can take a look at because it's directed towards one of your slides. But while you're taking a look at that, I think, Jim K., we might have confused folks. Do you remember when you showed the type of audits, and you said, "It can't be A or B or C, it's got to be A, B, and C? The YellowBook, the – A-133, and then the first one was the financial statements? I think – the person that wrote in, I think, was looking at – are those – are those three different reports? Are they going to come under different names or what – how do we know we've got those?

Jim K.: Okay. That's a good question. If you require a single audit, then it's got to be all three. If you don't require a single audit, it could be a YellowBook and the first level.

Ann: But if it requires all three...

Jim K.: Then there's three reports.

Ann: In one. But that's what the auditor does.

Jim K.: When the auditor presents the financial statements to you there will be three reports. Typically, there's two ways it can be – and this is purely just how the financial statements are bound. Typically, page one will be the audit report on Generally Accepted Auditing Standards. That's the – the normal – the first layer. Then – then you'll usually see the – the YellowBook report on governmental auditing standards and the single audit report in the back of the financials.

It's past the footnotes, past the schedule of federal awards, in the very back before the statement on questioned costs. Unless – but those can be bound separately. And that's – that's really an elective choice of the auditee as to whether they want those reports bound separately. The schedule of federal awards and the other – the YellowBook and the single audit report could be separately bound. Some organizations ask for that so they can hand out their financial statements without those three reports – or those other two reports in the back. But there's three reports. Each one speaks to the findings for that particular type of – portion of the engagement.

Ann: So I'm going to come back on another one also. You referred to Sarbanes-Oxley, and I think you shared that it's not applicable to nonprofits. I think maybe in California they – the state might have adopted Sarbanes-Oxley.

Jim K.: That would have to be... You're right. The federal act is not applicable to nonprofits. Each state then can determine whether or not – New York, I believe, also does.

Ann: So it's Sarbanes-Oxley that is that, sort of, regulation, but as it relates to Head Start grantees, our nonprofits, there is not a regulation that requires rotation.

Jim K: I am not aware of any federal agency or anyone, anywhere that requires it at this point.

Ann: But I think we would encourage folks to take a look at Sarbanes-Oxley because I think many people feel that that was very strong, positive legislation that came out governing for-profit organizations.

Jim K.: And as I mentioned, they are very much debating that very issue right now. And there is legislation right now being addressed to not – to require that they cannot regulate rotation, but it still is an important issue to discuss.

Ann: And I think, clearly, we've got a concern from folks in the field, and I think this is the second question that came in about this. The only type of finding that is going to require you re-compete – the agency re-competes for their funds is in fact that of a going concern. So if you take a look at the designation renewal rule and 1307 – I think it's 1307... I can't think of the exact, but go to 1307 and you will see where there is – ]they talk about the going concern as one of the conditions.

Belinda: We have it cited in the slides.

Ann: Oh, good. Okay. Great

Belinda: So it may not be the full text, but it will give you the citation for that – that cite.

Jim K.: And I typically don't call that a finding. You may – you may have used that. It's – it's an issue...

Ann: It's an.. Yes. Correct.

Jim K.: ...and that is going to be found – if that exists, it's going to be in the page one report.

Ann: Okay.

Jim K.: The Generally Accepted Auditing Standards report, the first one.

Ann: Belinda, can you help us with the...

Belinda: I'm going to try. I mean, the question, I think, is whether on slide 16 the – the summary language that talks about the agency making available to the public a report that discloses the results of the financial audit is consistent with the actual language in section 644. And Jim and I were both taking a look at it, and while it doesn't include all of the additional requirements for what needs to go into the – the annual report to the public, the section clearly identifies what is required.

Now, that's not to say that's all that's required, so hopefully those who read this don't think that the only thing that needs to go in that annual report is the fiscal information. But in terms of the annual audit, it is – the language of the Act actually says, "Each Head Start agency shall make available to the public a report at least once in each fiscal year that discloses..." And then it identifies this fairly lengthy list of information.

And one of those is the – the results of the most recent review by the secretary and the financial audit. And so, we – we skipped that bit of language just to focus on the audit. So it's certainly not the only thing that needs to be included, but – but it is required that the audit information be included.

Jim B.: I think the question submitter is doing absolutely the right thing. There's no regulation in this area, so they're going back and reading the Act itself.

Belinda: Right.

Jim B.: Perfect.

Belinda: Which I think is a really important point, Jim. Just as a – you know, a general hint, right now, because our Performance Standards haven't been revised since the Head Start Act of 2007, it's really important for those with fiscal responsibilities to take a really careful look at the Act, because I actually went through and counted and there are about 40 fiscally-oriented requirements that are specific to the Head Start Act that are generally reflected in other regulations, but not always. So it is important to look very carefully, as this viewer has done, at what those requirements entail.

Ann: So let me ask, Jim K... You're in the hot seat. "If our auditor cannot present the management letter to our board, would that be a red flag? Other alternatives?"

Jim K.: "Cannot" meaning that the board does not want them to?

Ann: Oh, no. It sounds like the auditor is not able to or not willing to.

Jim K.: Yes.

Ann: That would be a red flag?

Jim K.: I would – a red flag in that that auditor is not as engaged as they should be.

Ann: And does every audit come with a management letter?

Jim K.: No.

Ann: So we would first need to find out, is their inability to present it...

Jim K.: But every audit does result in the reports and the financial statements, which would warrant presentation also. Now one thing you need to be careful with though, as I said that pretty quickly, is I will often have a client that will say, "Well, management would like to meet with you before the audit, and the audit committee, a separate meeting before the audit. And then each one after the audit. And then we'd like you to present to the finance committee or – or the subcommittee or of the board of directors. And then – and by the way, we're having our board retreat across the state," or whatever.

So I think you have to make sure that if you want multiple meetings with your auditor that there is some type of cost to that. One should be a given; but if you're going to request multiple meetings, there may be some type of cost to that that you need to be aware of.

Jim B.: And I think we were both consistent in saying we highly recommended it. And given the requirements of the Act that you talked about, I don't know how the board can do this without really understanding the audit and talking to the auditor.

Ann: Here's one. I'm not sure that I understand it, but I bet you Jim and Jim will. "During a single audit, is materiality a major factor as in a" – it looks like, "U.S. GAAP audit."

Jim K.: Yes. It's just materiality for a – for a financial audit is based on the entire financial statement, whereas materiality for what we're looking at...is based on the major programs that you're testing. So it's not – you can't use the financial statement materiality calculation to measure materiality on the grant that you're testing. It has to be – it has to be recalculated based on that particular program.

Ann: We've got some smart people in the audience. And this one – you just set the house on fire here. Again, you talked about the tax credit, and they want to know exactly what that tax credit is. I think you explained it before, but really their auditor should be able to direct them and provide them...

Jim K.: They should – they should be able to... Again, if you didn't pay a penny into the IRS through a 990-T – you would never pay it through a 990 – you can – but you can still get a tax credit back if you qualify. And there are pretty strict qualifications, but my guess is the many organizations that are out there listening today – there are some that missed that.

Belinda: So Jim, if a grantee wanted to go talk to their auditor about it, how would they – how would they formulate what they're asking in the sense of, "Can you tell me more about the...?"

Jim K.: "I would like to find out if we qualify for the health care tax credit that is retrieved through the 990-T." And if the quick answer is no, then say, "Can you show me why we do not?" Because there are – there is calculations that need to be done, and if the grant – if the organization did not feed information

to the auditor to make that calculation, it probably wasn't made. So, I'm not saying that your auditor's lazy, but they may just not be aware of it, because there's a lot that aren't.

Ann: So I think this is a tough question, and I think a situation probably many grantees are facing. "If the agency loses three programs or three grants, our program receives budget cuts. Yet we now must pay more of the cost allocation because of the other lost grants." And the person asks, "Is there another option?"

And the thing that immediately came to my mind, which I'm not – maybe you could answer. I mean, we really don't know, other than getting more funds to spread the cost. But let's say three or four – let's say they're sharing the rent of a building. And let's say three grant programs are gone, and the little old Head Start program is now in the building. Now it was – they occupied a quarter of it, let's say. It was appropriate for them to pay a quarter of the rent. But if there's no other occupants, is it reasonable that they're now shouldering 100 percent of the rental cost when they're only occupying a quarter?

So, I'm – I'm adding onto this question. I mean, absorbing – taking on a greater burden for the allocation when there's fewer programs. There's still got to be a reasonableness attached to it.

Jim K.: Yeah. In the way that you set that up, it would – it would be reasonable that the Head Start program would pay the rent, but it's unreasonable that that's going to fit in that budget. They still can't pay more than what the budget allows for that. And – and so, it seems to me that they need to be looking for a new space.

Jim B.: I would take a look at the cost principles as well, the items of selected cost. I think idle capacity might be one of them. So it may not even be an allowable cost for Head Start.

Ann: We just – we've got one more question. One of our... Someone from the field wrote in a question and I didn't quite understand it, and I shared it with our colleagues and we didn't quite get what you were asking. So, it was around delegate agencies and grantees and pass-throughs and how to treat them. So I would urge you – if you just want to say, "Hey, email me at such and such and I can explain it." We do want to get back and we do want to be responsive.

Let's see. "Do we have any guidance for agencies" – Now I've got to put on my glasses. It's getting late and dark – "reporting on and being reimbursed on a cash basis but are audited and required to meet GAAP? Our concern are areas in which expenses are expensed and fully reimbursed and are later required to be reported on GAAP. For example, depreciation expenses and pre-paid expenses." Doctor, can you answer that one?

Jim K.: That's a good question. I do have a couple of clients, in the past and currently, that have elected to expense – they don't own a building, but expense fixed assets and have that as a qualification to their audit report. That is what I was saying earlier. That was a qualification that they have made a conscious decision to do, because all of their particular grantors require that – that they report those in the year that they're purchased, basically on a cash basis.

And so therefore, their – their audited financial statements are more mirroring how they're going to have to report that. So, that's one way around that. But having your – your internal records on a cash basis and then adjusting it to accrual at the end of the year, and that's the only time that that's looked at, could cause a lot of budgeting and cost allocation problems.

Ann: So I'm looking at the clock, and we have but six minutes. I want to give some time to Jeannie for some closing thoughts, but I wanted to thank the three of you so much for the valuable insight, the manner in which you made it less scary and very understandable. And we appreciate it, and I hope that the field benefitted today and is going away saying, "I wish it wasn't three hours long, but I got some very useful information." I hope that the materials that we post on ECLKC will be helpful and you can use them within your own grantee organizations. And Jeannie, we're thrilled to have you with us today.

Jeannie: Well, I'm just so pleased. And I echo your remarks about our panelists. I think they did a great job and – and made some tough subjects really understandable, so I appreciate that. And Ann, I just want to let you know and let Yvette know that we appreciate so much at OCS being invited and a recognition that community action and Head Start are in a partnership with this program, and we're really working together to strengthen communities and to help improve outcomes for children.

I think whether we're at the federal level, the state level, or the local level, we're all really working to achieve the same goals. And I think opportunities like these are very proactive to get us out in front of issues and be preventative. And today where we have tight resources and everybody is looking very closely at every federal dollar that's invested, I think it takes this kind of partnership and this kind of proactive approach to keep us in – in a good environment where people are proud of our programs and want to continue to invest in them.

So, I hope this is the beginning of a stronger partnership, more opportunity for us to work together and to look at issues together. And I'm just very pleased to be here. And thank – I know people are going to feel like this was helpful and the start of something really good.

Ann: Well, if I know the Head Start community, they will let us know one way or the other. [Laughter] But we want to promise to continue this dialogue with you. We think that – you know, our average grant now is over \$4 million. This is big business. It's serious business. And we know good fiscal health means a better chance for quality comprehensive services for our kids, and that's really what this is all about – our children and families that we serve. So thank you, and we wish you well and we wish you a happy audit. Happy trails. Thank you.

Jeannie: Good luck.